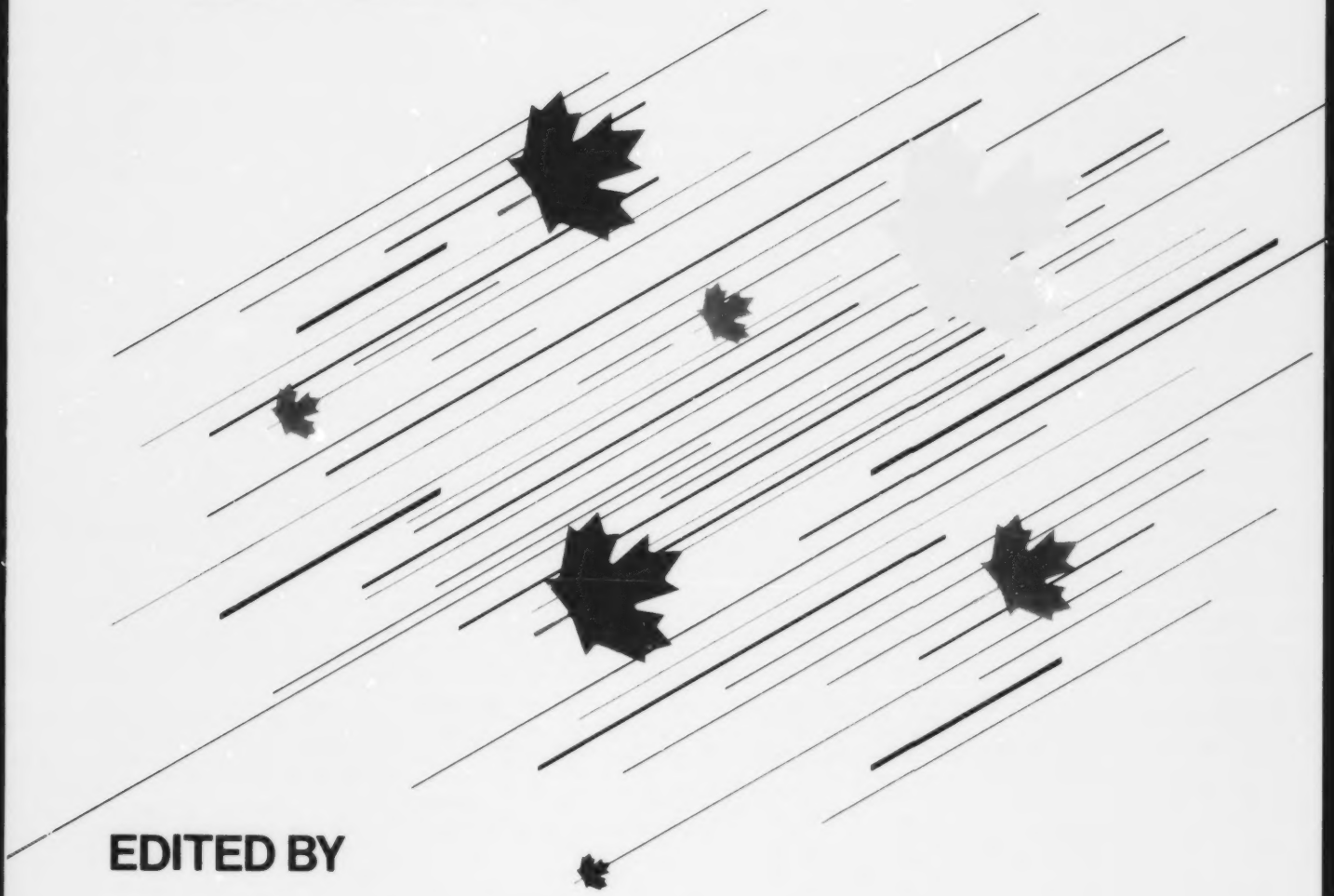
Approaches to Income Security Reform



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Foreword

Two major forces have put income security reform once again on the agendas of federal and provincial governments, as well as business, community and labour groups. On the one hand, it is argued that the income security programs now in place have not significantly alleviated poverty and unfair income distribution in Canada, goals that were viewed as important in establishing the social welfare state in the 1940s, 1950s and 1960s. More specifically, there has been recent concern regarding the inadequate response of public policies to the basic needs of the long-term unemployed, a concern prompted in part by the dramatic increase in the number of welfare recipients and unemployed since the recession of the early 1980s. On the other hand, a second impetus to reform emerges from the argument that the cost of income security programs, as well as the disincentives or deterrents to labour market re-entry by the unemployed that are created by programs such as unemployment insurance and social assistance, act as impediments to economic efficiency and international competitiveness.

Following the collapse of initiatives emerging from the federal-provincial Social Security Review of the mid-1970s, the question of income security has lain largely dormant on government agendas for almost a decade. But over the past three years, the momentum for reform has been stimulated anew by a number of reports dealing with income security issues. The Royal Commission on the Economic Union and Development Prospects for Canada (Macdonald Commission 1985) proposed a form of guaranteed income (the Universal Income Security Program or UISP) which would be financed by abolishing or cutting back many existing income transfer programs as well as a number of tax expenditures. Most recently the majority report of the Commission of Inquiry on Unemployment Insurance (Forget Commission 1986) sought to restore the primary focus of unemployment insurance as social insurance, while eliminating UI's social welfare

role. Forget proposed to deal with the latter through a new national income supplementation program for the working poor and the long-term unemployed.

At the provincial level, the Quebec *White Paper on the Personal Tax and Transfer System* (1984) shed light on the poverty traps and high implicit marginal tax rates faced by employable welfare recipients. It also proposed to categorize recipients on the basis of employability. In addition, after a certain period on the welfare rolls, employable recipients would have to be available for community work or for professional, vocational or private sector training programs in order to qualify for full benefits. The Newfoundland Royal Commission on Employment and Unemployment (House Report 1986) proposed an earnings supplementation plan (based on individual, not household, income) and a reform of the UI system in order to encourage local job creation projects. Another provincial inquiry on income security, launched by the government of Ontario, is the Social Assistance Review Committee, whose report is expected in the fall of 1987. Prompted by concern about the increasing number of welfare recipients rather than fiscal restraint, the Committee's task is to examine Ontario's system of social assistance and related labour market programs.

At the federal level, the House of Commons Standing Committee on Labour, Employment and Immigration tabled its First Report on Unemployment Insurance in March 1987. In its report, the Committee responded to the recommendations of the Forget Commission and proposed an alternative strategy for the reform of UI. The government will respond to the Committee's report in the near future. At the same time, the federal government is currently completing its review of social tax and transfer programs. The results to be anticipated from this work will depend to a large degree on the reform proposals that emerge from the federal Tax Policy Review and any resulting shift in the balance between corporate taxes, income taxes and sales taxes as sources of federal revenue.

Three reform priorities emerge from these reports and reviews: (1) a movement toward a guaranteed income, with an income supplementation plan being the most urgently required element – at present, Manitoba, Saskatchewan and Quebec are the only provinces with either income or earnings supplementation programs; (2) reform of the unemployment insurance program, strengthening its primary role as a social insurance program and compensating for elimination of UI's role as a social welfare program for the chronically unemployed through an income supplementation plan that would take account of family size and needs; and (3) greater integration or harmonization of income security and labour market programs, so as to remove the obstacles (poverty traps or high implicit marginal tax rates) faced by social assistance recipients wishing to re-enter the labour market and to encourage their meaningful participation in society. Federal and provincial governments are actively considering, and in some cases implementing, new policy initiatives in these three areas.

In light of these developments, the Institute for Research on Public Policy organized a Workshop on Approaches to Income Security Reform at its Ottawa office on 23 September 1986. The objective of the Workshop was to stimulate an informed debate on the reform of income security in Canada, focusing specifically on those parts of the income security system that provide social assistance and social insurance to the working-age

population. Participants included leading actors in the income security field from federal and provincial governments, from business, labour and community organizations, and from universities and research institutions. The resulting variety of perspectives and concerns produced a discussion that addressed a wide range of technical, political and strategic issues.

In the period leading up to the Workshop, the Institute sponsored several efforts in the area of income security policies. They included two reviews of the Macdonald Commission recommendation for a Universal Income Security Plan in the December 1985 issue of *Policy Options*, a proposal for integrating a guaranteed income with major personal income tax reform in the January/February 1986 issue, and an analysis of the distributional effects of UISP by income class and by household type in the September 1985 issue of *Choices*. Two papers commissioned for the Workshop were distributed in advance to participants. Richard Van Loon's paper, entitled "Discussion Paper on Tax and Transfer Reform", outlined the policy design issues and various reform models now being discussed in the welfare reform community, while Michael Wolfson's paper on "The Arithmetic of Income Security Reform" analysed the distributional and other implications of two illustrative reform options.

This volume is divided into two parts. The first is an Overview, which provides a synthesis of the major issues discussed at the Workshop, including a statement of areas where the Workshop reached consensus as well as areas where disagreement remains. The Overview concludes with suggestions as to a possible strategy for reform. The second section contains the background papers prepared for the Workshop by Richard Van Loon and Michael Wolfson.

In publishing this volume, the Institute hopes to encourage continuing discussion and debate about one of the key public policy issues in Canada today.

Rod Dobell
President

April 1987

Avant-propos

Deux phénomènes importants ont incité les gouvernements fédéral et provinciaux ainsi que les milieux d'affaires, les associations syndicales et les organismes communautaires à examiner de nouveau la possibilité d'une réforme en matière de sécurité du revenu. D'une part, on prétend que les programmes actuels de sécurité du revenu n'ont pas provoqué de recul appréciable de la pauvreté et qu'ils n'ont pas résolu le problème de la répartition injuste des revenus au Canada, objectifs jugés essentiels dans les années 40, 50 et 60 lors de l'avènement de l'État-providence. Depuis peu, on s'inquiète du fait que les politiques ne répondent pas aux besoins élémentaires des chômeurs chroniques, surtout en raison de l'augmentation considérable du nombre d'assistés sociaux et de chômeurs depuis la récession du début des années 80. D'autre part, la question de la réforme revient sur le tapis du fait que le coût des régimes de sécurité du revenu et les désincitations au travail provoquées notamment par l'assurance-chômage et l'aide sociale sont considérés comme des obstacles à l'efficacité économique et à la compétitivité internationale.

Les initiatives prises le cadre de l'Examen fédéral-provincial de la sécurité sociale au milieu des années 70 s'étant soldées par un échec, cette question est restée en veilleuse pendant près d'une décennie. Depuis trois ans par contre, plusieurs rapports consacrés aux problèmes de la sécurité du revenu ont ravivé le débat. La Commission royale sur l'union économique et les perspectives de développement pour le Canada (Commission Macdonald, 1985) préconise une sorte de revenu garanti (le Régime universel de sécurité du revenu), financé grâce à la suppression ou à la réduction de bien des programmes de transfert et de certains allègements fiscaux. Tout récemment, dans son rapport majoritaire, la Commission d'enquête sur l'assurance-chômage (Commission Forget, 1986) a recommandé d'introduire des changements qui renforceraient l'aspect assurance sociale du programme d'assurance-chômage et de cesser d'en faire une forme d'aide

sociale. La Commission Forget a préconisé d'instaurer à cet effet un supplément de revenu à l'intention des gagne-petit et des chômeurs chroniques.

Plusieurs initiatives ont été prises à cet égard par certaines provinces. Au Québec, le Livre blanc sur la fiscalité des particuliers (1984) a signalé que les assistés sociaux aptes au travail sont souvent assujettis à des taux d'imposition marginaux très élevés et à d'autres formes de pièges de pauvreté. On propose par ailleurs de les classer selon leur aptitude au travail. Par ailleurs, au bout d'un certain temps, les bénéficiaires aptes au travail devraient se mettre à la disposition de programmes de travail communautaire, de formation en industrie ou de formation professionnelle ou scolaire, pour continuer à avoir droit au plein montant des prestations. La Commission royale de Terre-Neuve sur l'emploi et le chômage (Rapport House 1986) a proposé un régime de supplément de revenu (basé sur le revenu personnel et pas sur le revenu familial) et une réforme de l'assurance-chômage afin de favoriser les projets régionaux de création d'emplois. De son côté, le Gouvernement de l'Ontario a institué La révision de l'aide sociale qui doit présenter son rapport cet automne. Ce comité, dont la création est dûe davantage aux préoccupations causées par l'augmentation du nombre d'assistés sociaux qu'à un souci d'économie, est chargé d'examiner le système ontarien d'aide sociale ainsi que les programmes d'embauche qui s'y rattachent.

Au niveau fédéral, le Comité permanent du travail, de la main-d'oeuvre et de l'immigration de la Chambre des communes a déposé son premier rapport sur l'assurance-chômage en mars 1987. Dans son rapport, le comité réagit aux recommandations de la Commission Forget et propose une stratégie différente pour la réforme de l'assurance-chômage. Le gouvernement devrait donner bientôt sa réponse à ce rapport. Par ailleurs, le gouvernement fédéral est en train de terminer son étude sur les programmes d'imposition et de transferts sociaux. Les résultats devraient dépendre largement des projets de réforme découlant de la réforme fiscale du gouvernement fédéral et de la nouvelle répartition de l'assiette fiscale qu'ils risquent d'entraîner.

Trois priorités ressortent de ces rapports et de ces études: 1) une poussée vers un revenu garanti, le supplément de revenu étant l'élément le plus urgent – à l'heure actuelle, le Manitoba, la Saskatchewan et le Québec sont les seules provinces à avoir des régimes de supplément de revenu; 2) une réforme du régime d'assurance-chômage afin d'accentuer son rôle premier, celui d'un régime d'assurance sociale, et de compenser la perte de son caractère d'assistance sociale pour les chômeurs chroniques par l'établissement d'un régime de supplément de revenu proportionnel à l'importance de la famille et à ses besoins; et 3) une meilleure intégration ou une plus grande harmonisation des programmes de sécurité du revenu et de réinsertion au marché du travail de manière à supprimer les obstacles (pièges de pauvreté et taux d'imposition marginaux élevés) auxquels se heurtent les assistés sociaux désireux de réintégrer le marché du travail, afin de les encourager à participer de manière significative au sein de la société. Les gouvernements fédéral et provinciaux sont en train d'étudier sérieusement et, dans certains cas, de mettre en oeuvre de nouvelles politiques pour essayer d'atteindre ces trois objectifs.

C'est dans ce contexte que l'Institut de recherches politiques a organisé un colloque sur les possibilités de réforme de la sécurité du revenu à son bureau d'Ottawa, le 23

septembre 1986, afin de favoriser la tenue d'un débat éclairé sur le sujet en se plaçant surtout au point de vue de l'aide sociale et de l'assurance sociale offertes aux citoyens ayant l'âge de travailler. Parmi les participants se trouvaient des représentants des gouvernements fédéral et provinciaux, des milieux d'affaires, des travailleurs et des organismes communautaires ainsi que des universités et des centres de recherche. Grâce à la diversité des points de vue et des centre d'intérêts, la discussion a porté sur toute une série de problèmes techniques, politiques et stratégiques.

Durant la période qui a précédé la tenue de ce colloque, l'Institut avait commandité plusieurs études sur les politiques de sécurité du revenu. Il y a eu notamment deux études sur la recommandation de la Commission Macdonald portant sur la création di Régime universel de sécurité du revenu, publiées dans le numéro de décembre 1986 d'Options politiques, un projet d'intégration d'un revenu garanti à une importante réforme du régime d'imposition des particuliers, dans le numéro de janvier/février 1986, et une étude sur l'incidence du Régime universel de sécurité du revenu selon la tranche de revenu et le type de ménage, parue dans le numéro de septembre 1985 de Choix. Deux documents, commandés pour le colloque, one été distribués d'avance aux participants. Celui de Richard Van Loon, un document de travail sur la réforme de l'imposition et des transferts, donne un aperçu des politiques à l'étude et des différents modèles de réforme examinés dans les milieux concernés, tandis que celui de Michael Wolfson intitulé "The Arithmetic of Income Security Reform" porte sur les répercussions distributionnelles et autres de deux formules de réforme choisies à titre d'exemples.

Le présent ouvrage se divise en deux parties. La première, l'Aperçu, fait la synthèse des grands sujets abordés au colloque en précisant les questions sur lesquelles il y a eu consensus et celles où subsiste un certain désaccord. Cette partie se termine par des suggestions d'ordre stratégique pour la réforme. La deuxième partie contient les documents préparés en vue du colloque par Richard Van Loon et Michael Wolfson.

Par la publication de cet ouvrage, l'Institut espère alimenter le débat sur un des questions politiques les plus importantes de l'heure au Canada.

Rod Dobell
Président

Avril 1987

Acknowledgements

Planning for the Workshop on Approaches to Income Security Reform began in the summer of 1986. We were greatly assisted in this task by Russell Robinson, Richard Van Loon, Raymond Protti, Michael Wolfson, and especially A.R. Dobell, who chaired the Workshop.

We are grateful to all the participants in the Workshop, including the authors of the background papers, not only for their contribution to the discussions, but also for the time they devoted to commenting on earlier drafts of the Overview published in this volume. We wish to extend our very special thanks to Michael Sabia, who worked with us tirelessly to ensure that the volume would be useful for policy purposes.

Finally, neither the Workshop nor the publication would have been possible without the administrative assistance of Leigh McGowan, Ruby Day and Donna McCafferty.

Part I

Overview

I. Introduction

This paper is based on the views expressed at an informal workshop on income security reform organized by the Institute for Research on Public Policy on 23 September 1986. Discussion at the workshop was often detailed and technical, reflecting the background and expertise of participants. By contrast, this synthesis of the discussion aims to reach a broader audience in the policy community, as well as in the business sector, labour and community groups and universities.

Participants had before them two background papers distributed in advance of the workshop (and reproduced elsewhere in this volume). Richard Van Loon's paper set out basic questions that should be answered before any reform is attempted, and defined the various elements that can be combined to create income security programs. Michael Wolfson's paper outlined two options to illustrate the current range of reform proposals. Because debate at the workshop turned frequently on the merits or shortcomings of these illustrative options, they are described briefly here:

- Toward one end of the spectrum, the option dubbed Modest Tinkering (MT) proposes relatively small changes in programs where the federal government has the power to act unilaterally. MT accepts that governments are severely constrained in their ability to introduce reform and should therefore attempt only relatively modest changes.

- Toward the other extreme, the Profound Demolition (PD) option envisages a comprehensive guaranteed income and simplified tax system. Most of the

current transfer programs and tax benefits would be replaced by a single system of guaranteed income and a flat basic tax rate.

To simplify examination of some of the complex questions surrounding income security reform, the next section of this paper, which synthesizes discussion at the workshop, is organized under five headings, each denoting a cluster of related issues:

- the objectives and implications of consciously pursuing distributional equity;
- the financing of income security programs through taxation;
- the interaction between income security policies and labour market policies;
- considerations arising from the respective roles of federal and provincial governments in income security; and
- strategic considerations underlying reform.

Following the synthesis we present our conclusions about the issues on which participants reached consensus, those where uncertainty remains, and the strategy for reform that these issues suggest.

II. Synthesis of Workshop Discussion

Equity: Objectives and Implications

By equity we mean fairness in the distribution of economic well-being among members of society. In the absence of a better yardstick, income is the generally accepted proxy of economic well-being, and increased equity can be assumed to follow from reductions in income inequality. Equity is at the heart of any discussion of income security reform; it is a factor in both the design and the effects of programs.

Income security programs reflect judgements about the degree of income inequality that is acceptable. These judgements may be stated explicitly or they may be implied by the way the program is designed. When policy makers decide on the level of benefits a program will guarantee people with no other income, or choose the rate at which benefits will be taxed back as a recipient's other income rises, their decisions determine the extent to which the program increases or reduces inequality in the distribution of income among members of society.

Just as important, these decisions have far-reaching implications for the cost of programs, whether that cost is defined in terms of actual expenditures on the program or consequences for the economy as a whole. A universal guaranteed income, for example, might improve equity but would also entail high program costs. If policy makers believe the improvement in equity is worth the cost, they must find some way to finance the

program. If the cost seems too high, they will have to determine just how much reduction in inequality is affordable.

This decision cannot be made in isolation, however, because income redistribution can have economy-wide consequences as well as direct consequences for program costs. Opinions vary as to whether reducing income inequality will improve the operation of the economy or hinder it. Some participants argued, for example, that increasing program benefits and increasing taxation to pay for them will dampen work effort by both program recipients and taxpayers. Recipients may not feel it is worthwhile to seek work if benefits are high enough, and taxpayers may reduce their work effort if their income is taxed at a higher rate to pay for a costly program. Thus it is argued that the pursuit of greater equity through income redistribution leads to increased direct costs for government in the form of higher program costs, as well as increased indirect costs for society as a whole in terms of lost output and lower economic efficiency.

This is by no means the only view, however. Other participants argued that the greater the equity in the system, the greater the degree of security for people in it. If social insurance provides better income protection during times of unemployment, people will feel less uncertain about change and less vulnerable to its effects. This will reduce their resistance to industrial adjustment, thereby removing barriers to growth in productivity and output and enabling the economy to compete more effectively internationally. This will lead ultimately to more jobs. Thus, a number of participants argued that strengthened social insurance provisions and greater efficiency can be mutually supportive rather than mutually exclusive objectives.

Both views rest on assumptions about people's behaviour in response to changes in program benefits and taxation. This makes decisions about distributional matters exceedingly complex. A second complicating factor is that equity is of two types, vertical and horizontal, and the two are interconnected.

Proposals for reforming income security are often assessed in terms of their ability to improve either horizontal or vertical equity. Vertical equity is the objective when income is redistributed from households at higher income levels to households at lower income levels. Horizontal equity, on the other hand, is achieved through the distribution of income among households of different types (in terms of size, composition, number of dependent children, number of income earners, etc.) regardless of their income level. Thus, a household with two dependent children would receive higher benefits than a household with similar income but no dependent children, in recognition of the greater needs associated with the cost of child-rearing.

A change in policy that improves vertical equity does not necessarily improve (and may, in fact, reduce) horizontal equity. For example, a policy such as converting the universal Family Allowance to an income-tested tax credit for the poor, which would improve vertical equity, would reduce horizontal equity for households at higher income levels. This is because middle-income households with children would lose benefits to which they were entitled under the universal Family Allowance, benefits that were

designed to compensate them for the higher costs they face relative to middle-income households without children.

Choices about equity must thus be made in light of the complex relationship between horizontal and vertical equity as well as their implications for both direct program costs and the overall efficiency of the economy. If governments had unlimited resources, these choices would be easier; but because the dollars available to government are limited, another solution is required.

The solution usually offered is to use the available resources to their best effect, directing more to those most in need and reducing the after-tax benefits to Canadians who do not need as much help. This in turn suggests the need for some method of distinguishing between groups of people with different income needs.

Participants agreed that the most acceptable criterion for categorizing welfare recipients is employability. This type of categorization enables distinctions to be made within the income security system regarding sensitive elements like guarantee levels and tax-back rates. (Interestingly, other criteria for categorizing people were considered much less acceptable by most participants. Particularly controversial, for example, is the age criterion used for welfare recipients in the province of Quebec, whereby adults under the age of 30 receive much lower welfare benefits than those 30 and over.)

Categorization on the basis of employability would result in a two-tier income security program: an income support tier, with a high income guarantee, for people not expected to be able to meet all their income needs through labour market participation, and an income supplementation tier, with a low guarantee, for employable people. Because people judged unemployable would be unlikely to earn substantial income from employment and would therefore be entitled to the high guarantee, the tax-back rate (the rate at which benefits are reduced as the recipient's employment earnings increase) for the support tier would also be high. By contrast, both the guarantee level and the tax-back rate for the supplementation tier would be low so as not to discourage employable people from earning income if they have the opportunity to do so.

While there was agreement on the desirability of categorization on the basis of employability, there was debate about what constitutes the appropriate test for employability. Should it be based only on the mental and physical capabilities of the individual, or should it also take into consideration the availability of jobs? The choice of the test would obviously affect the relative size of groups receiving the income support tier (with its high guarantee) and the income supplementation tier and would therefore affect the overall cost and affordability of the income security program.

In summary, equity is fundamental to discussions of income security in two ways: as a social goal that is valuable in itself and as a determinant of program design with implications for the cost of programs and the overall health of the economy. When the pursuit of equity conflicts with other objectives, such as expenditure restraint, policy makers look for ways to reduce costs while maintaining an acceptable degree of equity. Some participants argued that equity and cost reduction are not mutually exclusive; nevertheless, most accepted categorization on the basis of employability – if an acceptable

test could be found – as an ethically appropriate and fair way of keeping program costs manageable.

Financing Income Security Programs

New income security programs or changes in existing programs could be financed in several ways. Funds could be reallocated within the government's social spending envelope. The government could alter its spending priorities and reassign funds from another spending envelope. Reform could also be financed by borrowing (increasing the deficit) or by raising personal, sales or corporate taxes to increase government revenues to match additional expenditures.

Most participants agreed that it would not be realistic at this time to expect governments to reallocate resources from other spending envelopes for income security reform. Also, the scope for reallocating resources within the social policy envelope was assumed to be limited. Of the two remaining options – increased borrowing or raising taxes – it was generally felt that the former would not be acceptable.

In short, most participants agreed that proposals for reform should aim to be fiscally neutral. That is, if reform involved additional program expenditures, it would have to be financed by increasing taxation or by shifting tax burdens or spending priorities. The net result would have to be no long-term change in the deficits or surpluses of federal and provincial governments. (It was generally recognized, however, that income security expenditures fluctuate over time. They tend to rise in difficult economic times because their purpose is to provide income protection or replacement in just such periods.)

Participants found the concept of fiscal neutrality both a useful tool and the basis of a practical approach. As an analytical tool for comparing one reform proposal with another, fiscal neutrality is a convenient benchmark. If two proposals for income security reform contain different benefit guarantees and are financed with different levels of taxation, they can be compared more easily if both are fiscally neutral.

In the current climate of budgetary restraint, fiscal neutrality also reflects a realistic assessment of what is possible and practicable. With some exceptions, participants agreed that fiscal neutrality is desirable; even those who thought concern about government deficits is misplaced agreed that the current climate is unlikely to change significantly in the short term.

With fiscal neutrality as an assumption and an altered tax structure of increased taxation as possible mechanisms for financing any additional expenditures, the question that emerges is where the additional tax burden should be placed. According to preliminary estimates by the Department of Finance for 1985-1986, about 43 per cent of federal tax revenues came from personal income taxes, 12 per cent from corporate taxes, and 22 per cent from federal sales and excise taxes, suggesting ample room to shift the burden. This observation is particularly relevant in light of the current review of federal

tax policy and the present division of the tax burden between the personal income, corporate income, and consumption tax bases.

As participants pointed out, however, shifting the tax burden is not a panacea because changes in tax law do not translate directly into changes in the tax burden. If corporate taxes were raised, for instance, the result could be increased consumer prices, reduced wages for corporate employees, or even reduced prices paid to suppliers of raw materials, depending on a company's power in the marketplace. In other words, the actual change in the tax burden could be far different from the objective envisaged by an increase in corporate taxes. Because of this, policy makers face an additional complication in designing income security programs and determining how to finance them.

Policy makers have a similar problem predicting how people's behaviour will change in response to changes in program benefits and levels of taxation. Both the MT and the PD option (which are oriented toward opposite ends of the range of possible reforms) involve increased tax credits or income guarantees (relative to the status quo), along with higher taxes for middle- and upper-income Canadians as a result of increasing tax-back rates on universal benefits and eliminating some tax exemptions.

What these and other reform proposals cannot predict is how behavioural changes on the part of beneficiaries and taxpayers might affect the benefits actually paid out or the tax revenues actually taken in. In other words, proposals can claim fiscal neutrality only on the assumption that subsequent behavioural changes will in some sense offset or cancel each other out.

The costs or benefits generated by behavioural changes can occur on both the taxation or financing side and the expenditure side of income security programs. On the taxation side, some participants argued that if marginal tax rates go up to finance increased social spending, middle- and upper-income Canadians may well decide that there is little to be gained by efforts to increase their income. As a result they might spend less time working and less effort improving or acquiring skills. They might also look for ways to pay less tax on the income they do earn. All these changes in behaviour would make the economy less efficient, increase unemployment, reduce productivity, and lower government tax revenues.

On the expenditure side, disagreements about the behavioural effects of increasing benefits are similar to the debate about improving equity. Some participants see desirable consequences both for individuals and for general economic performance; people would accept the need for economic adjustment more readily if they felt secure about the income guarantees available to them in times of difficulty. Others believe that higher income guarantees simply discourage individual efforts to improve financial status and pose barriers to economic growth.

Predictions of undesirable consequences are based on the assumption—although there is little empirical research to support the proposition—that higher guarantees would encourage people to remain on the welfare caseload and the unemployed to rely on social assistance instead of looking for work. To counter this response, Wolfson's PD

option tries to encourage individual efforts to find a job and stay employed by reducing the tax-back rate (relative to the rate that now applies to social assistance payments) for people in the income supplementation tier, i.e., those who have been categorized as employable. If only a small fraction of their additional earnings were taxed back, it would make sense for them to improve their skills through training and make other efforts to increase their earnings.

Moreover, because the PD option lowers tax-back rates by a greater amount than it increases guarantees, some participants argued that the net effect would be an increase in work effort. If this argument is correct, higher guarantees in this particular context would actually improve rather than hinder economic performance and would reduce government deficits in the process.

As was the case with the effects of improved equity and changes in tax policy, it is very difficult to predict how behaviour might change in response to modifications in program benefits and financing. Traditional economic theory assumes, for instance, that people act on the basis of their actual and expected marginal tax rates. Some participants pointed out that this supposition may be incorrect as far as working Canadians are concerned; most are probably unaware of their marginal tax rates or are operating on the basis of mistaken assumptions about them.

The same may not be true of Canadians receiving social assistance; many are aware that tax-back rates and work-related expenses would soon eat up any financial improvement that might be gained by giving up welfare benefits and services to take a job.

In summary, participants agreed that any income security reform would have to be designed to be fiscally neutral, but they were not able to agree on the optimum method of financing reform (i.e., increasing taxation, shifting tax burdens or shifting spending priorities). The issue of financing is complicated by the difficulty of predicting how benefit recipients, taxpayers and corporations will respond to changes in taxation and income security policies.

Income Security and Labour Market Policies

If the workshop reached firm consensus on one principle, it was that policy makers must find ways to promote the self-sufficiency of people receiving social assistance and encourage their meaningful participation in society. There was also agreement that the way to reach this goal was to eliminate the poverty traps that create long-term dependence on social assistance by erecting major disincentives to recipients entering the labour market.

Poverty traps result from the piecemeal design of particular components of the income security system as well as the inappropriate design of individual program components, especially high tax-back rates. Welfare recipients who find regular employment may experience either very little financial gain or an actual decline in income as a result of tax backs. Moreover, even if the loss of social assistance payments is

more than offset by the new wage income, the recipient no longer has access to the other benefits that accompany social assistance – free prescription drugs and eyeglasses, shelter allowances and so on. Moreover, with the new wages come income tax and increased expenses – child care, transportation and the like.

Workshop participants therefore agreed that a first concern must be to eliminate any prohibitively high effective or implicit marginal tax rate whose effect is to discourage people from entering the labour market because they have little or nothing to gain – or something to lose – by doing so. But beyond removing poverty traps, there was no consensus on what other steps should be taken to facilitate the transition from welfare dependency to regular employment. Participants generally held to one of two positions – what might be termed the supply-side view and the demand-side view.

The supply-side advocates argued that policy efforts should concentrate on helping people present themselves for employment in the labour market. Taxation policies and transfer programs should be harmonized to reduce the disincentives for welfare recipients to enter the labour market, and income guarantees should be reduced to remove any incentive to remain on the welfare rolls. In addition, government should promote training programs and offer incentives and financial assistance for people to move to another place or seek training to improve their chances of getting work. In addition, the supply-side approach may entail measures to promote flexibility in the labour market, such as relaxing minimum wage laws and other employment standards.

Promoting flexibility would help generate economic activity and thus stimulate the demand for labour. However, some participants advocated a more direct approach. While agreeing with need for harmony in tax and transfer programs, along with training and mobility incentives, the demand-side advocates pointed out that such steps are of little use if there are no paid jobs available. Thus they argued for programs aimed at increasing the demand for low-skilled labour – public sector job creation and wage subsidies to private sector employers prepared to hire former welfare recipients, for example.

Neither approach is free of flaws. The supply-side prescription of reducing income guarantees was criticized on the grounds that this change by itself would do little to encourage people actively to seek paid employment, unless the reduction were so large as to create real hardship, even for those who had no hope of finding work. Critics also pointed to the difficulty of ensuring that training programs are training people for occupations where there is (or will be) demand for more workers. This is particularly problematic given the difficulty of predicting occupational shortages. Thus, the provision of training does not necessarily ensure that trained people will have jobs.

The demand-side approach also has its detractors. Critics argued that subsidies or incentives could go to employers to take steps they might have taken anyway. As well, people now employed could lose their jobs to those in subsidized wage programs or public sector job creation projects.

Thus, neither prescription offers a completely satisfactory way to end welfare dependency and promote self-sufficiency at adequate income levels. What is most likely

needed is a combination of supply-side and demand-side policies, but finding the optimum mix will remain a complex problem.

Federal-Provincial Issues

The current income security system consists of a complex mesh of federal and provincial responsibilities, programs and funding arrangements. No comprehensive reform proposal can ignore the need for co-ordination between the federal and provincial elements of the income security system. Even reforms by one level of government to programs under its exclusive jurisdiction have implications for programs administered at the other level.

From the federal government's perspective, reform proposals have to be structured in such a way that new or increased federal benefits actually reach their intended targets. This means that provincial income tax and social assistance programs would have to be adjusted to ensure that any increase in benefits translated directly into increased incomes for recipients.

To illustrate the potential problem, one participant pointed out that the relatively generous guarantees offered under Wolfson's PD option could crowd out current provincial top-ups. If that occurred, the benefits received by targeted groups would amount to only a fraction of the actual increase provided by the federal government; the remainder would flow into provincial coffers.

Provincial governments have different but related concerns. The absence of a federal-provincial cost-sharing agreement covering income and earnings supplementation plans is a strong budgetary disincentive for provinces to set up such programs. If they took the initiative on their own, provinces would take on expenditures that would otherwise have been cost-shared with the federal government (social assistance, through the Canada Assistance Plan) or financed in other ways (unemployment insurance, through employer and employee contributions).

Given the interdependence of federal and provincial income security programs, unilateral action is not desirable. A related issue is the potential tension between the federal government's desire for national standards and the specific needs of different provinces with respect to income security. Despite the tendency to want to treat all beneficiaries of a national income security program in the same way, such a program would have to be flexible enough to suit the needs of different provinces. The program would have to allow provinces to set different income guarantees, for instance, or change other program provisions to respond to regional differences in economic conditions and labour markets.

The interdependence of federal and provincial income security programs, as well as the tension associated with maintaining federal standards in the context of regional variations, suggest the need for active consultation to ensure co-ordination of policies at both levels of government.

Strategic Considerations Underlying Reform

Three types of strategic considerations are important in income security reform: the public mood with respect to income security reform, the identity of the potential winners and losers from reform, and the uncertainty about the likely results of reform.

The first question is the extent to which Canadians are interested in income security reform or have expectations about it. Is there, in other words, a constituency pressing for reform? Some participants argued that the public mood reflects disenchantment with the current system, suggesting a body of support for income security reform. On the other hand, beneficiaries of the current system have entrenched interests and may feel threatened by the prospect of change. As well, middle-income Canadians, many of whom think governments see reform as a way of reducing the deficit by greater targeting to those in need, are nervous about the prospect of higher taxes or reduced benefits.

On the other hand, momentum for tax reform already exists, a fact that might tempt strategists to try to make income security reform part of comprehensive tax reform. Even that strategy, however, would require a constituency numerous enough, vocal enough, powerful enough (relative to other groups), and organized enough to ensure that social policy considerations are incorporated adequately into overall tax reform.

Just as important as assessing the public mood and discovering the constituency supporting reform is identifying the potential winners and losers from reform. Any income security reform will create immediate winners and losers or will at least lead people to perceive themselves initially as being in one category or the other. The two-fold challenge is, first, to design a reform package and a strategy for implementing it that do not create an unmanageable group of losers that would be in a position to block reform and, second, somehow to balance the potential losers with the potential winners. Doing so requires a knowledge of the nature and number of likely winners and losers, their regional distribution and their needs.

A third factor complicating the implementation of income security reform is uncertainty about the outcome of reform. Throughout the workshop participants pointed to gaps in our understanding of the effects of policy changes on the behaviour of people and corporations, on labour market operation, and on economic performance.

In summary, there is no clear picture of the public mood and the nature of the constituency favouring income security reform. Furthermore, the complexity of identifying winners and losers and predicting behavioural effects of income security reform suggest that there are real barriers to our understanding of the potential impact of reform. As will be seen below, these strategic considerations strongly suggest a careful, gradual and incremental approach to income security reform.

III. Conclusion

Our conclusions about the direction reform should take and the strategy reformers should adopt are based on two components: the areas where workshop participants reached consensus and the areas of uncertainty or disagreement that remained.

Areas of Consensus

Participants agreed first and foremost that reform must aim at enabling as many welfare recipients as possible to become self-sufficient and to participate meaningfully in society. They agreed that eliminating poverty traps is the first step toward this goal. There was recognition, of course, that there would remain a number of people – such as the elderly and the seriously disabled – who could not be expected to work and would require income support.

This recognition led to the second area of consensus, which was agreement regarding the advantage of a two-tier benefit system, with a test of employability used to distinguish between the tiers. Subject to the condition that the employability test include some measure of the number of jobs available as well as the standard measure of physical and mental employability, participants thought this was the best design solution to the problem of preserving some degree of fairness while keeping program costs reasonable.

Third, most participants agreed on the need for fiscal neutrality; if reform requires additional expenditures, these can be financed only through tax reform, increased taxation, or reduced spending in another policy envelope, not through increased deficits for federal or provincial governments. It was generally recognized that deficits might increase during periods of economic difficulty, but the current attitude toward containing the deficit will not likely change soon.

Finally, consultation and co-ordination between federal and provincial governments are essential in light of the interdependence of their income security systems. They would also help develop a balance between federal and provincial interests in the income security field and contribute to solving policy design problems arising from the interaction between federal and provincial programs. There was recognition, of course, that co-ordination will not be a simple task.

Remaining Uncertainties

The disagreements that continue to divide participants are based in part on uncertainties about the results of policy changes and in part on differences in approach to perceived problems.

The first area of disagreement centred on the relative merits of approaches to promoting transition from welfare dependency to self-sufficiency through regular

employment. While there was consensus on the need to remove poverty traps, there was debate about what other steps are needed to promote the transition. Problems were identified with both supply-side (e.g., training) and demand-side (e.g., direct job creation) labour market policies. At a more general level, there was also debate about the trade-off between providing some form of guaranteed income and placing greater emphasis on full employment policies. This trade-off emerges for two reasons. First, limited resources suggest that a choice may have to be made between providing income support and labour market assistance. Second, some held the view that, from a technical perspective, it may be complicated to provide both a guaranteed income and certain types of employment assistance, such as wage subsidies, at the same time.

A second area of uncertainty is how people and corporations will respond to changes in income security benefits and tax policy. It is very difficult to predict behaviour or to assess how behaviour will affect efficiency, productivity, industrial adjustment, labour mobility, and the other factors that contribute to economic performance and international competitiveness. Given this uncertainty, decisions such as whether to raise or lower benefits, or whether and where to shift the tax burden, will not be straightforward. It will also be difficult to determine whether reform proposals can actually achieve the objectives they envisage and are as fiscally neutral as they claim.

A third area of uncertainty is our insufficient understanding of how best to ensure harmonization between federal and provincial reform of income security systems. While consultation is essential, the actual co-ordination of change at both levels of government will be complex.

Finally, there is considerable debate about the key strategic considerations underlying reform. The public attitude toward reform is not clear, and there are barriers to our understanding of the outcome of reform in terms of winners and losers and behavioural effects.

A Proposed Strategy For Reform

In short, participants reached consensus on only a few, albeit important, principles to guide reform. The outcome of the workshop was particularly sobering because it emphasized the complexity of the issues surrounding reform and the barriers to an adequate understanding of the consequences of reform.

While it was recognized that there are deficiencies in the present income security system, and that there is a need – first and foremost – to assist the transition from welfare dependency to paid work, there was no agreement on what type of comprehensive income security reform package would best ensure this transition. There was agreement only on the first small steps to take, such as lowering marginal tax rates so as to encourage employable welfare recipients to seek paid work.

The conclusion of the workshop was therefore that reform should be implemented in an incremental way. The concept of "adaptive management" was emphasized. Incremental change makes possible a managed social experiment where policy makers

can learn by doing, monitor changes, and adequately compensate and protect losers with particular needs. Research and consultation would play important roles in facilitating such incremental change.

Finally, given the uncertainty of the public mood with respect to reform, an incremental approach – if implemented sensitively – could reassure Canadians that reform is both necessary and beneficial, thereby alleviating the insecurity of those groups that feel they have most to lose.

Part II

Tax and Transfer Reform[1]

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Introduction

This paper is intended to help focus discussion about future directions for reform of the tax and transfer systems in Canada. It was prepared for a workshop sponsored by the Institute for Research on Public Policy. It poses several basic questions that should be answered before the next stages of program reform are undertaken. It then reviews a number of design elements that are combined in different ways to create income security programs. The questions and design elements are intended to be illustrative rather than exhaustive, for one of the purposes of the workshop was to determine whether we are asking the right questions and suggest an agenda for the 'next steps' and for policy research in this area.

After examining the questions and the design elements we go on to consider five program proposals or reform packages that have been put forward in Canada over the last 15 years. The purpose of this brief review is to elicit discussion about the range of possible reforms. Each proposal has good and bad features; none can simply be adopted as the most desirable route to income security reform. Seminar participants may be able to indicate which features could be adopted from each proposal in moving toward income security reform.

There are also several issues on which income security reform may become needlessly stalled. These include claims that the size of government bureaucracies will be reduced by reform, the universality/selectivity debate, and arguments about incremental versus comprehensive reform. In my view these are issues that distract attention from the more important quetions involved in income security reform.

In the final section of the paper, we consider routes that might realistically be followed if workshop participants agree that comprehensive reform of the tax and transfer systems is a desirable goal.

Questions for Income Security Reform

Several important questions must be answered before choices can be made among the various options for income security reform. In general these are political questions, best answered by elected officials or by people acting in their role as citizens rather than specialists or interested parties. The answers to these questions constitute a framework within which program designers can develop options. It is usual in policy design for specialists or technicians to suggest what these questions should be; they have sufficient grasp of the available data to know what can realistically be answered and know what political advice they require in order to proceed with program design. In this section, then, readers should ask whether these are the right questions and whether there are other questions that should be answered before we move to the next stage of program design.

The first, most basic, question is simply this: Who do we want to help? Do we want to provide more and better assistance to

- the welfare poor
- the working poor
- those who are almost entirely outside the reach of current systems
- the unemployed, regardless of income
- identifiable groups such as native people, women, the elderly or disabled people?

To those on the left of the political spectrum the answer is very likely to be "all of them", while those on the right may well answer that we cannot afford to help even those we now support. Realistically, however, even if we are sympathetic to welfare expenditures, we are unlikely to be able to provide as much as we might wish for everyone. On the other hand, even if we are inclined to reduce income security expenditures, no one would seriously suggest eliminating all support for everyone. Some ranking of priorities is therefore necessary. For example, if we wish to assign the highest priority to assisting the working poor, we should concentrate more on income supplementation programs in this round of reform. If we wish to provide higher levels of support for the welfare poor, we will concentrate first, though not necessarily exclusively, on improving the Canada Assistance Plan.

The second basic question: What do we know about how to help these people? Other questions follow quickly from that. Should we work to improve programs already

in place, or are our existing programs so flawed that they must be changed radically? What can we learn from other countries' attempts to help people in similar situations?

The third question is – how do we want to provide the help? Should it be in the form of money, services, or some combination of the two? To what extent do we want to rely on work-related programs? To what extent do we want to ensure the integration of reformed income security systems with other programs such as social insurance (Canada Pension Plan, unemployment insurance), tax and transfer payments, social and medical services, employment programs or housing policies?

How will we pay for reform? This is the fourth question. All income security reform implies a redirection of resources and, while economic growth could lubricate the reform process, changes will necessarily redistribute income among Canadians. This question is never easy. As the Minister of Finance remarked in another context, "Canada does not have enough rich people" – in this case, to bear the costs of income security reform. Any downward distribution of income therefore implies costs for middle-income Canadians.

All the program designs outlined in this paper are based on the assumption that the costs of redistribution are to be borne inside the personal tax and transfer system, but it is important to recognize that improved assistance to low-income Canadians can also be effected by moving money from the corporate to the personal tax system. For example, a comprehensive income security reform proposal by the Netherlands Scientific Council would have been financed entirely through increases in the Dutch value-added tax system. Until recently it might have been assumed that no such possibility existed in Canada, but the July 18, 1986, announcement by the Minister of Finance that he was considering a broad approach to tax reform, reviewing corporate and personal taxes together, may open up new possibilities.

The fifth question derives from the fact that income security reform will do more than simply redistribute income. We must therefore ask what issues other than those related strictly to income distribution or service delivery are particularly important in the context of income security reform? Do we want to influence the workings of the labour market and if so how? To what extent are we concerned about the impact of programs on the structure of families? Are there public works that might be built or public services that might be provided as incidental benefits of the programs? What would be the effect of any attempt to make extensive use of public sector job creation programs on collective bargaining and the structure of public sector labour organizations? And, not least, what are the likely political ramifications of what we propose? If proposals are potentially suicidal for a government, is there any reason to pursue them?

Most of the designs for reform now under discussion among academics and the welfare reform community in Canada already assume answers to many of these questions. All assume that:

- more downward redistribution of income is desirable;
- cost savings are not a primary motivation;

- the major target groups are the welfare poor and the working poor (although alternatives differ in emphasis on this question);
- the most reliable identifier of need is reported income (often income reported for tax purposes);
- the primary concern is money transfers rather than service delivery;
- integration between the personal tax and personal transfer systems should be improved (but little attention is paid to integrating services and transfers);
- social insurance programs (in the form of unemployment insurance and Canada/Quebec Pension Plans) should be based on insurance principles, with premiums related to expected payouts. The use of social insurance programs for purposes such as regional development is inappropriate, and non-insurance objectives such as income redistribution should be achieved through other programs;
- social insurance schemes should be integrated with income transfers by defining social insurance income as identical to non-transfer income;
- reforms should be paid for by reallocating money inside the personal income tax and transfer system, essentially from middle- to lower-income Canadians. No current widely discussed Canadian scheme suggests financing the program via corporate taxation; and
- the labour market can be improved by removing disincentives to work (these are implicit in the very high marginal tax rates applied to to any earnings of social assistance recipients) and by supplementing the incomes of the working poor.

Because most reform proposals share them, these assumptions can be defined as a sort of emerging consensus *among reformers* regarding income security reform in Canada. It is important to note, however, that there is a gap between the convictions of welfare reformers and those of many other Canadians, including some key ministers in the current government, regarding some of these assumptions. For example, the preference of the Minister of Finance, as revealed in the 1985 and 1986 budgets, is not toward the downward redistribution of income.[2] As well, cost savings may well be a primary motivator of many in senior policy positions advocating reform. This situation obviously poses a difficult dilemma for those engaged in policy design.

The Elements of Income Security System Design

Over the several decades that we have been operating and trying to improve income security systems, broad agreement has emerged on the basic elements that can be varied in the design of programs. These include eligibility, guarantee levels, tax-back or

reduction rates, family unit definition, payment methods, accounting and accountable periods, delivery systems, required work or adjustment effort, and systems integration. These elements are reviewed briefly here.

a) Eligibility

Eligibility for a program depends on an answer to the question – who is the program designed to assist? Is it to be available to everyone, subject only to screening tests such as income or work effort, or is it to be available to certain categories of people, such as women, the elderly, native people, single parents, disabled people or families with children? As a matter of administrative convenience at least, almost all income security programs have some degree of categorical eligibility. Thus, although social assistance may be technically available on a non-categorical needs-tested basis to all residents of a province, in fact, it may be available far more readily to a single mother with preschool children than to an able-bodied unattached youth.

There is ample room for confusion among the terms 'universal', 'selective', 'categorical' and 'non-categorical'. Many people equate categorical eligibility with selectivity. In fact, however, if we define universality to mean the delivery of *initial* benefits at the same level to everyone who is eligible for the program, categorical programs can be either universal or selective. Conversely, in the real world of program delivery, almost all non-categorical programs are selective in practice. Except in response to an unavoidable question, the dubious pleasure of explaining this situation to a busy minister or the prototypical person-on-the-street should be assiduously avoided by anyone knowledgeable about tax-transfer reform.

We return to the question of eligibility after examining the issues surrounding guarantee levels, tax-back rates and break-even points.

b) Guarantee Levels, Tax-Back Rates and Break-Even Points

Guarantee levels are the benefits paid to recipients who do not have other income. The tax-back rate (sometimes called the reduction rate) is the rate at which benefits are reduced as the recipient gains other income. The tax-back rate may be explicit for a particular program, as is the 5 per cent rate applied to Child Tax Credit or the 50 per cent rate applied to the Guaranteed Income Supplement (GIS). Alternatively, the tax-back rate may be implicit in the normal rate system if the benefit is defined as taxable income. Thus the implicit rate applied to Family Allowance benefits is equal to the marginal tax rate of the parent earning the higher income, and the rate for Old Age Security (OAS) is the same as the recipient's marginal tax rate.

Tax-back rates can also be 'stacked'; that is, if a recipient receives benefits from more than one source, then the tax-back rate may be the sum of the rates applied to the income security programs for which the person is eligible and his or her marginal rate of personal income tax. Thus, if a family receiving Family Allowance and the Child Tax

Credit has an increase in earnings, they will face a reduction of the pay raise at the normal income tax rate, a potential reduction of Family Allowance if the pay raise moves the higher earner to a higher tax bracket, and a loss in the Child Tax Credit equal to 5 per cent of the increased earnings. For that family, then, the effective marginal tax rate is higher than for a family with comparable earnings but no children. (Of course, the family with children still receives tax and transfer benefits not available to families without children.) Any income transfer program whose benefits are defined as taxable income (e.g., Family Allowance and OAS) or that has its own tax-back rate (e.g., the Child Tax Credit and the Macdonald Commission's proposed Universal Income Security Program – UISP) creates a potential stacking problem when combined with the personal income tax.

Care must be taken in designing programs that the stack of rates does not become so high as to constitute a barrier to work. Stacking may create a particular problem for people in the low and middle ranges of the income tax system. For example, the 20-per cent tax-back rate applied to benefits in the Macdonald Commission UISP proposal, when combined with the current income tax system, would create marginal tax rates in the range of 50 to 60 per cent for families with incomes between $10,000 to $40,000. Although most would have more money as a result of the proposal, the stacked tax rate could have some work disincentive effect. That is why analysts such as Michael Wolfson have suggested that proposals like that of the Macdonald Commission should be combined with a flat-rate tax system or with changes in marginal income tax rates for lower income earners.

The combination of the guarantee level and the tax-back rate determines the range of incomes over which benefits are received. The level of income at which all benefits from a program disappear is called the break-even level or sometimes the turning point. Obviously a high guarantee level and a low reduction rate can combine to create a high break-even level, resulting in the supplementation of incomes up to very high levels. For example if we raised the Child Tax Credit to $750 and continued to apply a 5-per cent tax-back rate starting when family income rose above $20,000, we would be supplementing the incomes of three-child families up to $65,000 ($20,000 + 3 × 750 ÷ .05).

It is possible to avoid some of these problems by designing systems with no tax-back rate. Two of the systems outlined below depend upon relatively low-level credits available to everyone; no tax-back rate is applied and benefits are topped up to higher levels either directly or through publicly supported employment for those whose needs are greater. This creates a simpler, though not as finely targeted system. A few bank presidents will receive payments, but they can easily assuage any feelings of guilt or outrage by donating the equivalent to charity.

c) Two-Tier Proposals and Work Tests

Veterans of the income security wars will know that if we provide guarantee levels that are adequate for those with no other income and if we combine these with tax-back rates that are sufficiently low so as not to constitute a major work disincentive, we will

create extremely expensive programs that supplement family incomes to exhorbitantly high levels. For instance, if we provide an income guarantee at the National Council of Welfare 1986 poverty line for metropolitan families of four ($21,705) and apply a 25-per cent tax-back rate, we will be providing benefits to families with incomes of up to $86,820. Such a program is not likely to sell politically and, in any case, is essentially illusory, because many of the recipients would also be paying for the system. On a modest scale, Family Allowance depends on such an illusion. On a major scale, it may be less acceptable.

Income security veterans will also know that in response to this, many Canadian income security reform proposals since the early 1970s have been two-tier proposals. They seek to get around the problem just outlined by dividing recipients on the basis of some form of work test. Although these tests have had a range of names, they all ask essentially the same question: can this individual or family unit be expected to earn a significant amount of money through employment? If the answer is no, either because jobs are not available or because of family structure (single-parent families with little education) or severe disabilities, then that family becomes eligible for a program with both a relatively high income guarantee and a high tax-back rate. Conversely, if the recipient is employed at a low-paying job or could be expected to find such employment, then the family is eligible for a program with a lower guarantee to supplement earned income but also a lower tax-back rate to encourage work effort. The first type of program, intended mainly for the welfare poor, has generally been referred to as a support program; the second, intended mainly for the working poor, is usually called a supplementation program.

Two-tier program designs can be used to keep costs to a more reasonable level while also providing higher benefits to those who most need help and lower tax-back rates for those to whom program designers want to provide work incentives. In fact, the current combination of programs, including social assistance and the other tax-transfer programs, already constitutes a de facto two-tier system. Because the programs have developed somewhat haphazardly, much is left to be desired in the overall program design. However, it may bear emphasis that simplicity in two-tier program design is not likely to be achievable because judgements do have to be made about who would be eligible for the higher guarantee levels.

All recent major reform proposals have been of the two-tier type. In 1975 it was called 'Income Support and Supplementation'. The Macdonald Commission called the supplementation tier the Universal Income Security Program and anticipated provincial top-ups as the source of the higher benefits. Another proposal by Jonathan Kesselman for the Macdonald Commission suggested a basic low level universal grant combined with massive employment programs to provide the higher level benefits. Only those with no employment prospects would receive a higher income transfer. All these proposals use some form of work test. In the Income Support and Supplementation proposal it was Employment Availability Testing, and in the Kesselman proposal it is acceptance of assisted employment programs, if available. In the Macdonald Commission proposal the test is 'adjustment effort' in the Transitional Adjustment Assistance Program as well as current provincial work tests.

d) Family Unit Definition

Income security programs must be designed so that an individual or group of people is subject to an income test as a basis for determining the level of benefits. For unemployment insurance that unit is the individual. In social assistance programs it is usually the residential family unit. The Child Tax Credit considers the income of both parents, provided they live together with the child. The income tax system is based on the individual, but the complex combination of exemptions, credits and transfers between spouses means that the real income unit is, to some degree, the nuclear family.

No family unit definition is neutral. The lower OAS/GIS benefits available to married couples (compared to the benefits received by two singles) are widely held to constitute a disincentive to marriage among the elderly. It could be argued that the payment of a different rate on behalf of the first and second children of single parents on social assistance or the Macdonald Commission UISP constitute incentives to form artificial one-parent, one-child units. The payment of full benefits at the single rate to youths may constitute an incentive for them to leave home earlier than they otherwise would. There is no simple rule to follow, but close attention must be paid to these effects.

e) Payment, Accounting and Accountable Periods

The *payment period* is the length of time between payments. Obviously a system where payments are made weekly can respond much more rapidly than one where payments are annual; indeed, one of the most serious criticisms of the Child Tax Credit was that although it is targeted at low-income families, its annual payment period meant that money came too late and too 'lumpily' to be really helpful to those who need it. That problem was rectified to some extent by the pre-payment of a portion of the benefits to low-income families in November each year. One of the major objections to delivering major transfer programs through the income tax system has always been that the payment period (annual) is too long. In fact, however, for a person subject to income tax deductions at source, the payment period would be the same as his or her pay period, and for others it may be possible to make direct payments more than once a year through the income tax system.

Payment periods are not necessarily the same as *accounting periods*. The accounting period is the period over which need or income is assessed. For example the accounting period for GIS is annual but the payment period is monthly. Longer accounting periods are more efficient administratively, but they can create trouble if income fluctuates rapidly; if that occurs, payments may bear little relation to need.

Finally the *accountable period* is the period over which benefits received are reconciled with entitlements and the extent of underpayment or overpayment is determined. The income tax system has an annual accountable period for most earned income but, in effect, the accountable period for capital gains is the taxpayer's lifetime. The UI system, intended to be rapidly responsive, has weekly accounting, accountable and payment periods. Long accountable periods – one year or more – may mean that some

beneficiaries receive substantial excess benefits that will later have to be recovered by the system. The problems this creates for low-income recipients are obvious.

f) Delivery Systems

Debate about the appropriate nature of delivery systems revolves around two issues: whether programs should be delivered by the federal government or by provincial governments and whether they should be based on demogrants or on the tax system. It is essential to note that these issues are related to *how and by whom* benefits are delivered, not to the level and distribution of benefits. In theory, any desired degree of income testing, and any combination of tax-back rates and guarantee levels can be delivered through either a negative income tax or a demogrant system and by either the federal or provincial governments.

In practice, however, there are likely to be real and important differences. A tax-based system could be cheaper to administer, but unless we develop administrative mechanisms to deliver payments on a regular basis to those who are not subject to tax withholding at source, we may have a less responsive system than is desirable. The trend in federal policy over the last decade has been toward tax-based systems rather than demogrant delivery. There is by no means total agreement, however, that this is the appropriate direction for change.

Provincial governments could deliver either or both tiers of a two-tier system, but experience with the Canada Assistance Plan has led some to have reservations about putting the entire income security system in the hands of provincial governments. In any case, unless the program is accompanied by a massive increase in equalization payments or a vast new cost-sharing arrangement, most provinces would be financially unable to mount an adequate system. There would also be a great increase in bureaucracy as new provincial and territorial systems were set up. For these reasons, most reform proposals, particularly those intended to supplement the incomes of the working poor, have tended to move toward an enlarged federal role. This creates one of the greatest barriers to reform, for the administrative and fiscal dictates may take us in a direction unacceptable to some provinces.

Both the federal-provincial and the tax/demogrant issues pose difficult strategic dilemmas. On one hand, federal-provincial reviews of income security programs have tended to bog down in disputes. On the other hand this is an area where both orders of government are active and where there are great potential benefits to co-operation. In the face of those considerations is it desirable to encourage the federal government to go it alone or to engage in extensive consultations with provincial governments? With regard to the tax/demogrant issue, the reform momentum appears to be with tax-based delivery systems. To what extent is it desirable to go along with and encourage that momentum in the face of some significant questions about tax-based delivery?

In any case, it appears generally agreed that future delivery systems should be cost-efficient and able to respond rapidly. There is perhaps somewhat less agreement that they should encourage high take-up rates among those who are eligible, be simple enough

for the recipient to understand their entitlements and eligibility, and be free of the stigma that characterizes some current systems.

g) System Integration

An important element of income security design is the degree of integration between it and other elements of government programming. In particular, attention is usually paid to integrating reform design with the tax and social insurance systems, with housing programs and, far less frequently, with social service programs. Integration with the 'positive' tax system may be facilitated by tax system delivery, but it is quite possible to adjust nominally independent tax and transfer systems so that they work well together. It is sometimes suggested that integration would be facilitated by a flat-rate tax system; what is essential, however, is that the design of benefit structures in the income security system and rate structures in the tax system pay sufficient attention to ensuring that the stacking effect referred to earlier does not become excessive. It is easy enough to develop models to do that; but those instructing program designers must tell them what effective rate does seem desirable. That, in turn, depends on answers to two questions: who should benefit and who should pay?

It is generally proposed that integration with social insurance programs, most notably UI, be achieved by changing the UI so that it is more strictly an income replacement program, with benefits related only to previous earnings and employer premiums varying with the risk of lay-offs. This would result in substantial reductions in UI eligibility, a shorter benefit period for some, and high premiums for firms with a history of lay-offs, but it need not result in lower weekly benefits for those who are eligible. Income security programs could then be put in place to protect those whose incomes from employment and social insurance are insufficient to meet their needs. UI payments would be treated like any other income in determining the income security benefits to be paid. The Macdonald Commission and the Kesselman proposals are both of this type. The 1975 Orange Paper proposals were essentially similar.

It can be anticipated that program integration of this type will mobilize opposition among those who would lose current UI entitlements but whose incomes might be too high to qualify for other benefits. Such proposals will also cause concern because of their regional effects. The report of the Forget Commission has focussed this debate again.

Reform proposals seldom give much thought to integrating of service delivery and income security programs. There are income tests for some social service programs, such as subsidized day care, but those dependent on social assistance or with very low incomes from employment and social insurance generally receive services free – if the services are available at all.

One form of integration could be achieved by providing fully adequate income guarantees to all and then applying full charges for services; but income security reform in Canada does not seem likely to provide adequate benefits for that. Alternatively, charges for non-emergency social services could be applied as the inverse of the tax-back rate in the income security system (e.g., a recipient receiving three-quarters of the

guarantee level in the income supplementation tier would pay one-quarter of the full rate for a service). This type of integration, which takes place through the social service system rather than the income security system, is similar to existing housing subsidy systems where the subsidy level is determined according to other income and accommodation costs.

By now it will be obvious that a great deal of flexibility is possible in designing income security programs. Left to themselves, those responsible for designing new programs must either make assumptions about the goals to be achieved or go on forever spinning out new program designs. It is therefore important to have answers to the sorts of questions posed here.

As examples of the types of systems that can be designed, five approaches to reform are reviewed briefly here.

Recent Reform Models

a) Amended CAP

If a primary objective of reform is to assist the welfare poor, then it is possible, in theory at least, to achieve a great deal by amending and expanding the Canada Assistance Plan. The federal government has already offered to reduce the prohibitive 100-per cent tax-back rate that applies to social assistance recipients beyond the work-related expenses exemption, provided they are in receipt of training allowances in training programs. Reduced tax-back rates, perhaps in the 50- to 75-per cent range, for all social assistance recipients would create a layer of benefits much like the support tier of most two-tier programs. At various times several provinces have experimented with lower reduction rates, with various degrees of success in obtaining federal cost sharing under CAP.

Although these reforms would be worthwhile, they may not be adequate for several reasons:

- provincial and municipal governments may choose not to use new CAP provisions;
- variations in benefit levels from province to province may be appropriate because of varying local conditions, but the degree of potential variation under CAP may be too great; and
- the social assistance component of CAP has been constructed to be a needs-tested instrument, intended primarily to deliver a single tier of benefits to people who cannot be expected to earn significant employment income. Thus, while CAP reform intended to assist the welfare poor may be considered a

worthwhile exercise on its own, any reform large enough to encompass a significant number of working poor would likely require new legislation.

b) The Canadian Council on Social Development Approach

An incremental approach to tax-transfer reform was put forward by the CCSD in its 1985 Discussion Paper on Social Security. The Council proposal begins with changes in the family benefits package, including the married exemption, then expands on that base to more comprehensive reform. It proposes to convert the married exemption ($3,470 at the time the proposal was made) to a non-taxable, refundable credit of $1,050. It would set Family Allowance at $360, making it non-taxable, but would eliminate the Child Tax Exemption, diverting the savings to enlarge the refundable Child Tax Credit. The net result would be to provide a basic child benefit of $900 per year. The Council would subject the Child Tax Credit portion of the benefit to a tax-back rate of 15 per cent, starting at incomes over $30,000. Higher-income families would continue to receive, untaxed, the full $360 Family Allowance benefit as well as the $1,050 married tax credit if one spouse was not in the labour force. Benefits would be paid in the form of a single monthly "Family Assistance Allowance" cheque, with the level of the cheque determined on the basis of the previous year's income.

In effect this plan would provide all families with two adults, one of whom is in the labour force, and two children with a guarantee level of $2,850, subject to a 15-per cent tax-back rate at incomes above $30,000 but with a payment of $1,770 remaining even for higher-income families.

The rest of the Council's proposal is worked out in less detail. For singles the Council suggests converting the personal exemption to a refundable credit. The funds now devoted to the exemption would provide $1,025 per year in the form of a flat-rate credit for all singles regardless of their other income. If the credit were subjected to some form of tax-back, the guarantee level could be made commensurately higher. For the elderly, the Council continues in the direction of replacing tax exemptions with tax credits, in this case proposing that the government replace the age exemption and the pension income deduction with refundable credits. Once again the credit could be delivered as a non-taxable payment or could be subject to a tax-back rate that would allow higher guarantees to be paid. The current OAS, GIS, and the Spousal Allowance would be left intact, but the net impact would be the delivery of a higher level of benefits to the poorest of the elderly.

In the Council's preliminary proposals, disabled people would be entitled to full CPP retirement benefits, plus the OAS, regardless of age. For those without CPP entitlements, the GIS and the Spousal Allowance would also be available. The tax exemptions of $2,480 (1985 level) for the disabled and $1,360 for wholly dependent children over 18 would be converted to credits.

The unemployed would receive more support outside the Unemployment Insurance program. UI recipients would be referred automatically to training or employment development after four months on benefits. Additional dollars would be provided for local

economic development where long-term economic development seemed possible. As well, direct job creation funds would become available in a region once the level of unemployment rose above a pre-determined level. Intensive skill development and job support would be provided for school leavers, and permanent community service-related employment would be provided for those most difficult to employ. Several other features are suggested under the heading of Employment Development, of which the most important is stronger minimum wage legislation so that the income supplementation provided under the Family Assistance Allowance would not merely result in lower wages. Greater emphasis on equal pay legislation, work sharing, paid skill development leave and a flexibile retirement age is also suggested as part of the comprehensive package.

The Council proposals are consistent with the general consensus on design features noted earlier. The Council's Discussion Paper on Social Security rightly notes that the proposals constitute too large a package for a government to implement at one time; but large parts could realistically be phased in, starting with the Family Assistance Allowance and moving to the modest package of reforms for the elderly. The next step could be to convert the personal tax exemption to a refundable credit. At that point Canada would have a package essentially the same as the income supplementation tier proposed in other reform packages. The second tier, consisting of guaranteed employment programs for the chronically unemployed and a package of changes for the disabled, could be phased in at any time in the process, as could other employment programs and personal social service reforms.

In sum, the Council package recognizes the need for greater tax-transfer integration and better support for Canadians with the lowest incomes through the conversion of an array of exemptions to credits. The proposal also results in an income supplementation scheme for the working poor, eventually improves the second tier of benefits for the disabled, and improves targeting and administrative simplicity. It is consistent with both the general consensus on design features in the income security reform community and current directions in federal program change.

c) The Macdonald Commission Approach

The objectives of the Macdonald Commission approach to income security reform were to

- provide a broad measure of support in a period of adjustment for Canada;
- simplify the system;
- provide more support to lower-income Canadians;
- improve work incentives in the tax and transfer system;
- introduce no net increase in the cost of the system; and

- return UI to a social insurance basis, combined with support and adjustment assistance for those directly affected.

The report therefore recommended a series of changes:

- elimination of all regional and special benefits under UI, introduction of experience rating (with employer premiums related to past lay-off experience), and reduction in benefit levels from 60 to 50 per cent of insurable earnings;
- reallocation of UI savings to a massive Transitional Adjustment Assistance Program (TAAP) to support training, mobility and portable wage subsidies for the long-term unemployed;
- elimination of a series of federal tax and transfer programs and of the federal CAP social assistance contribution, replacing them with a federally delivered Universal Income Security Program providing an income guarantee of $2,750 per adult and $750 per child (1984 figures), with a tax-back rate of 20 per cent applied to family income. A second, richer option would have eliminated the personal exemption and raised the guarantee levels to $3,825 per adult and $765 per child;
- UISP could be delivered through either the tax or the transfer system, but the Commission expressed a slight preference for transfer system delivery because of its more rapid responsiveness for those not subject to income tax deductions at source; and
- a request to provincial governments to continue to provide social assistance top-ups as a second tier for the unemployable.

These proposals were widely criticized with respect to details, but they were fairly widely supported with respect to general directions. The criticisms include the following:

- the inadequacy of guarantee levels for the welfare poor, both in dollar terms and because they are reliant on provincial governments;
- the elimination of all child benefits for higher income families constitutes a failure to recognize that the tax and transfer systems should provide some compensation even for upper- and middle-income families for the cost of raising children;
- inadequate integration with the tax system, resulting in excessive marginal tax rates in the $10,000 to $40,000 income range; and
- inadequate provision of employment opportunities for beneficiaries who are not in the labour force.

There are also major objections to the proposed UI reductions. As well, the proposals are sometimes faulted for being overly comprehensive and therefore impossible to implement. Perhaps significantly there has been little comment from provincial governments.

Some of the criticisms can be dealt with by more sophisticated program designs. For example, inadequate benefits could be dealt with by continuing the Canada Assistance Plan in its current form or with a tax-back rate of 75 per cent while eliminating the personal income tax exemption and adding the amounts thus freed to the general UISP payment. More adequate tax-transfer integration could be accomplished by adjusting marginal tax rates at the low end or introducing a flat-rate tax system with a broader tax base. To recognize the costs of raising children, child benefits could be taxed back to one-half the guarantee level and then kept at that level for higher-income families.

Other criticisms may be less compelling than they first appear. Laid out in a single document, the proposals seem very comprehensive, and although the Commission argued for their early implementation, it would be a brave government indeed that moved on all fronts at once. However, treated as longer-term objectives toward which we can move incrementally, the proposals could be generally achievable over time. In total, they are no more comprehensive than the CCSD package outlined earlier; indeed, they share many of the same elements.

d) Employment-Based Programming

Several of the criticisms levelled at the proposals put forward in the main report of the Macdonald Commission could be dealt with through an approach advocated by Jonathan Kesselman in a study prepared for the Commission. Kesselman proposes a lower guarantee level in the first tier of the system ($1,200 per adult and $720 per child with no tax-back on the benefits). Access to the higher tier of the system would be determined on the basis of whether the combination of the basic guarantee plus other transfer and employment income was adequate for family needs. If it were not, one member of the family would be certified as eligible for supplemented employment, with a wage subsidy in the private sector or a low-level service or public works job in the public sector. Only if no suitable employment of either type could be found would the family become eligible for higher (second-tier) support payments. In common with the main Macdonald Commission proposals, Kesselman would place UI on a pure social insurance basis, but he proposed to use the savings to finance an employment program rather than a Transitional Adjustment Assistance Plan.

Kesselman's proposal has several desirable features, including

- easier integration with the positive tax system;
- the provision of employment for many beneficiaries; and
- a simple benefit structure for the lower-tier benefits.

It also has significant disadvantages, including the threat of very substantial employment displacement of currently employed people by those on supplemented wages or in low-level public service jobs. Kesselman's proposals are described in detail in

Volume I of the Commission's research studies. Although it adopted some of the Kesselman plan, the Macdonald Commission chose not to adopt the entire proposal, primarily because of its labour market implications.

e) The Income Support and Supplementation Program (1972-1975)

Some readers will recall that during the Social Security Review of 1972-1975 the federal and provincial governments developed a two-tier income support and supplementation system. The options being considered were spelled out in the 1975 "Working Paper on Income Maintenance" published by the federal government. The design most favoured at the time was a shared-cost arrangement to be delivered by provincial governments; the federal government would carry two-thirds of the cost of a supplementation program with a maximum guarantee level of approximately $100 per month (1974 dollars) and a minimum 33 per cent tax-back. The federal government would also share one-half of the support program, with a higher maximum guarantee level and a higher minimum tax-back rate (75 per cent). Within the maximum and minimum levels specified, provinces were to be free to set their own benefit levels.

Eligibility for the supplementation tier was to be essentially non-categorical, based only on an income test, while eligibility for the support tier was to be based on an employment availability test, to be administered by provincial governments. The operative question was to be – can some member of the family unit be reasonably expected to find employment? If the answer was yes, eligibility for support was to be denied. Unemployment insurance was not affected by the proposal, and income from UI was to be treated as income from employment. There were other variants based on tax credit delivery and on various categories of age or family structure, but the universal shared-cost variant was the preferred option.

The proposal was hung up on the twin shoals of provincial reservations and the federal Cabinet's concern about the potential costs of the program (it was proposed as an add-on to the tax and transfer systems then in existence). Its demise after 1975 marked an end to consideration of major income security reform as part of the public agenda for almost a decade. It remains, however, the most detailed of the major reform proposals and the only one based on provincial delivery of a classical shared-cost program.

Conclusions: Can we get anywhere from here?

a) Some Dangerous Red Herrings

The proposals outlined above by no means exhaust the range of available options. We have not even attempted to describe the most complex and comprehensive of the major reform proposals, that of the Quebec White Paper of 1984. It should be clear by now, however, that there has been no shortage of design work with respect to major income security reform. What has been missing for the last decade is a clear message that reform

is desirable and reasonably clear answers to the questions posed at the start of this paper. In the absence of a clear mandate for program designers, the debate has tended to snag on relatively unimportant issues. The most perilous of these has been the universality-selectivity debate.

i) *Universality and Selectivity*

As defined by most program designers, universal and selective programs can have the same final impact on beneficiaries; the issue is merely whether the final level of benefits is determined before the benefit is paid out or a portion will be taxed back from some recipients after the benefit is paid. For the vast majority of Canadians who are subject to tax withholding at source, there is, in practice, no net financial difference between universal and selective delivery of such programs as Family Allowance. What is given with one hand in the form of a Family Allowance cheque is removed with the other in the form of withheld tax.

The federal government may wish to ensure that Family Allowance cheques continue to appear in Canadian homes and are as large as possible, but the most important issue for the beneficiary is the final result. The question of pre- or post-delivery testing of benefits is not entirely trivial, but it certainly should not distract the debate from more important matters.

ii) *Tax or Transfer Delivery*

The debate about whether to deliver benefits through the tax system or in the form of demogrants is more important but again should not distract us from the basic questions. Either system can, in theory, be made responsive, and both can deliver the same net benefits. The problem with tax system delivery through the current system is that it can now deliver benefits only once a year to those who do not have deductions made at source. Because many of these people are unemployed and in need, annual delivery is not sufficient if the benefits constitute a major portion of their income. But that is not to say that a tax system cannot be made to deliver benefits more frequently – if instructions from the government are sufficiently clear.

iii) *Reducing the Bureaucracy*

The claim that comprehensive income security reform will greatly reduce the size of the bureaucracy should be viewed with some scepticism, and its statement as a goal of reform is likely to lead to disappointment. For reasons outlined earlier, only two-tier systems are likely to be effective. Such systems will require a test procedure for admission to the higher (support) tier and, probably, some individual tailoring of benefits within that tier. Moreover, none of these schemes by itself will reduce the need for social services, many of which have little to do with supporting or supplementing income.

iv) *Incremental versus Comprehensive Reform*

Finally, the debate about the wisdom of incremental versus comprehensive reforms should not be allowed to delay action, provided we can agree on the overall direction for reform. Canada's experience suggests that we will not move in one great leap, or even a couple of bounds, to total reform of the system. But we can adopt a comprehensive reform blueprint toward which we move in a series of planned steps, such that we consolidate each step before moving to the next and never expose those who depend significantly on the systems to excessive risk.

b) So How Do We Get Anywhere?

If we accept that incremental reform is essential if anything is to be accomplished, then the question is, what steps come next? Fortunately, the income security system is far from static: virtually every federal budget in the post-war period has made some significant change in the tax or transfer arrangements that together constitute income security. The problem is not, therefore, getting a static system into motion, but guiding momentum that already exists. If we accept that proposition, then the problem is to discern the current direction of change so as to determine what guidance should be given to move the system in the direction we want to go.

It has been suggested that an emerging federal approach may be discernible in recent changes in the child benefit system. In 1978, a refundable Child Tax Credit was put in place. In the April 1983 budget the Child Tax Exemption was frozen but the Child Tax Credit was to continue to rise. In 1985, Family Allowance payments were partially de-indexed, and the Child Tax Exemption was set on a declining path that will eventually bring it to the Family Allowance level. The Child Tax Credit was to increase in value in partial compensation. A refundable sales tax credit was also instituted in 1986; in effect, this introduced the principle of a non-categorical refundable credit into the system. These changes have moved significant components of the income security system from an exemption and demogrant base to a tax credit base.[3] Indeed it can be claimed that the basic framework for a generalized negative income tax system is now in place.

The key move in converting to a significant negative income tax would be to convert the personal tax exemption to a refundable credit. That move is probably too large a change to expect from a government in the period immediately preceding an election. Over the next two years, however, the Minister of Finance could concentrate on cleaning up the personal income tax system by converting other small exemptions to equivalent refundable credits. At the next stage it would be necessary to determine the capability of a tax-based system to deliver benefits on a regular and frequent basis to people not subject to deductions at source. This could be done by rolling the three components of the child benefit package into a single benefit as suggested by the CCSD and making regular payments to low-income families with incomes not subject to deductions at source.

An alternative, not really much different in practice, would be to enlarge the Family Allowance to include all the elements of the current child benefit package and then subject it to a special tax-back rate.[4] Experience with this reformed child benefit package could then be used to roll the married exemption into the package to create what would be, in effect, the Family Assistance Allowance proposed by the CCSD. A reasonable target date for completing that part of the reform would be approximately five years from now, so that it would be operating smoothly by the time an election came along two years after that (in approximately 1993). The conversion of the personal exemption to a credit – the final major step in the package – could be done without ever using the sometimes frightening designation, 'guaranteed annual income'; instead the exemption could be phased out gradually and the savings moved into an expanding sales tax credit.

The combination of federal moves toward a classic negative income tax and a re-negotiated Canada Assistance Plan could move Canada's income security system incrementally in the direction of the two-tier model generally favoured by program designers. This emerging reform strategy could be workable, provided that:

- eligibility for the support tier can be defined adequately and provincial governments can be induced to deliver adequate support benefits under new cost-sharing arrangements with the federal government; and
- the tax-based delivery system can be made responsive enough to take account of the fluctuating needs of low-income families.

This approach has several advantages. At no stage in the reform process is it impossible to stop. Each step is an improvement over the present system, and each step in combination with what is left in place leaves us with a viable system that is better than what preceded it. If the tax-based system proves too difficult to operate when we move to a single child benefit, we can take steps to move more elements of the system to a transfer payment basis. The reform strategy also has the advantage of being workable at whatever level of funding the government considers appropriate. It will not necessarily create any particular pattern of redistribution. The design parameters can be varied to achieve whatever income distribution pattern seems desirable. It is in that sense value-neutral: although most of those engaged in designing it might prefer that reform be used to redistribute income downward, this approach does not trap the government of the day into doing that.

These considerations would seem to suggest that this type of reform is feasible and perhaps even inevitable. However, it will not have escaped observation that these are in some respects only partial reforms. They do not, for example, make significant changes to unemployment insurance, nor do they incorporate major employment initiatives. In view of the possibility that high rates of unemployment and difficulties with productivity will persist, along with the certainty that regional development will crop up whenever public programs are under discussion in Canada, it may well be desirable to go further with reforms of UI and employment-related programs.

Significant changes in the regional benefit structure of UI and other major changes such as experience rating are likely to be very difficult to achieve unless it can be

demonstrated that the most vulnerable among low-income Canadians will not be harmed by the changes. Change is thus likely to be more feasible once it can be shown that income security reforms already in place will provide that support. It may therefore be desirable to delay major changes that would move UI back toward a classical social insurance program until at least the point where the married exemption is converted to a credit; more probably, change should be delayed until the personal exemption is added to the package. Of course, a government might consider that it is necessary to move quickly toward reform rather than adopt an approach that would not see all reforms in place until at least 1993. The judgement will have to be left to the government of the day.

Notes

1. This paper is a revised version of one prepared originally for the Canadian Council on Social Development.

2. See *The Impact of the 1985 and 1986 Budgets on Disposable Income*, National Council of Welfare, Ottawa, April 1986 and *Overview*, Vol. 3, No. 1, Spring 1985, Canadian Council on Social Development, Ottawa. The former notes (p. 19) that the impact of the 1985 and 1986 budgets on a one-earner, two-child couple will be to reduce disposable income for families in the $11,000 to $30,000 range by approximately two per cent in 1990. For families with incomes of $80,000 and over, the impact will be to raise disposable income slightly.

3. As the National Council of Welfare points out in *The Impact of the 1985 and 1986 Budgets on Disposable Income*, the changes also reduce the level of benefits for most lower-income families from what they would have been under the pre-1985 system. Our concern here, however, is with delivery modes rather than levels of benefits.

4. The use of this approach would make it evident that, in practice, the difference between tax and transfer delivery is not great, provided tax system delivery is on a refundable monthly basis.

The Arithmetic of Income Security Reform

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Introduction

There has recently been an increase in discussions about a guaranteed income in Canada. After the failure in the mid-1970s of the federal-provincial Social Security Review, there was a hiatus that ended recently with several royal commission reports, discussions linked to political party platforms, and federal government announcements of forthcoming reform initiatives in the areas of income security and taxation.

The purpose of this paper is to provide a quantitative analysis of two options for income security reform, both of which move in varying degrees toward a comprehensive guaranteed income. The intention is to provide a more concrete and specific basis for discussion and debate on income security or tax/transfer reform, initially as a starting point for a workshop organized by the Institute for Research on Public Policy.

By design, the two options are polar opposites; one is a package of incremental reforms, while the other is a 'big bang' reform package. The purpose is to illustrate the wide spectrum of possibilities that can be considered. The reform options are intended to be provocative insofar as they draw out or elaborate certain basic trends or choices in the

* This paper reflects the personal views of the author. The current text is somewhat revised based on the discussion at the Workshop and documents that have subsequently been published. The policy analysis content of the paper draws principally on the author's experience prior to joining Statistics Canada. The empirical and methodological content, on the other hand, draws on the Social Policy Simulation Database/Model (SPSD/M) project at Statistics Canada. This is a new database and modelling tool that will shortly be available to the public as a product of Statistics Canada.

current policy discussion. For example, the two options are designed to give readers a basis for considering the following kinds of questions:

- Can Canada afford an adequate guaranteed income?
  - Is the amount of redistribution required from the well-off to the needy "within reason",
  - can this be done without increasing the deficit, and
  - will the resulting guaranteed income be adequate?
- Must reform of cash transfer programs be coupled to income tax reform?
- Can major simplification of the income tax and income transfer system be achieved?
- Can a big-bang style of income tax/transfer reform be implemented step by step?
- Can a reform package be designed that both targets cash transfers better and does not penalize women?
- Can these same kinds of reforms improve targeting while still giving middle-income families an important interest in (or solidarity with) the net benefit position of the poor?
- Can major reforms in this area remain sensitive to federal-provincial relations concerns?

While the reader will have to judge, the thrust of the analysis is to suggest that, in general, answers to the above questions may be affirmative. In the case of the first question, an affirmative answer casts doubt on Walker's (1980) claim that a guaranteed income in Canada is arithmetically impossible because there simply is not enough income in the hands of the rich to redistribute. He said that it is a "myth that . . . we can achieve more equality or more social justice by taking from the rich [and] giving to the poor . . . [without] resorting to draconian measures of taxation which have the ultimate effect of destroying society's collective ability to produce material well-being". The thrust of the present analysis suggests a different answer with respect to the arithmetic feasibility of a guaranteed income.

The analysis begins in the next section with a brief review of the recent history of guaranteed income proposals in Canada. Then we begin defining two options for tax/transfer reform that are almost polar opposites. The process of definition starts with a set of objectives and constraints. Both options take as a starting point the objectives enunciated by the Minister of Finance in his February 1986 budget speech regarding income security reform. They diverge after that, with one option tending toward a set of smaller incremental reforms while the other is much more sweeping and fundamental in scope. The former option accepts a variety of constraints while the latter seeks to meet additional objectives.

Because we are working with a broad canvas of government programs and tax provisions, many with involved federal-provincial and other interactions, both options are necessarily complex. The option for more fundamental reform in particular is premised upon a major conceptual change: the full integration of the personal tax and transfer systems, with transfers simply negative income taxes and vice versa.

Once the two options have been defined, we turn to the question of what is an adequate income. The guarantees or benefit improvements under the two options are compared to both the poverty or low-income lines of various social agencies and the guarantees currently provided by provincial social assistance programs. When all the provisions of the two reform options are put together, the resulting benefit guarantees represent at least modest improvements over the status quo and, in some cases, approach the levels of some of the poverty and low-income lines.

The main part of analysis follows with the quantitative simulation of the two reform options and comparisons to the status quo. This analysis shows both options to be broadly redistributive from upper- to lower-income groups. However, they diverge in their redistributive effects between men and women and in their overall effects on the elderly and families with children. Perhaps more interesting, even though both options involve billions of dollars of redistribution compared to the status quo, these changes are still relatively small compared to the redistribution already taking place within the existing income tax and transfer systems.

The analysis continues with a discussion of possible transition strategies, mainly for the fundamental reform option. Several strategies are sketched out; in so doing, it becomes clear that this option can be characterized in more than one way with very different connotations. It can be seen as converting personal income tax exemptions to demogrants or, alternatively, to refundable income-tested tax credits. For example, from one perspective, the Family Allowance is implicitly tripled; from another it is abolished and replaced by income-tested benefits with a structure more like the Guaranteed Income Supplement.

More broadly, from some perspectives the option may appear to be a step toward a social assistance style of programming designed simply to prevent poverty; from other perspectives it may be seen as broadening the social security aspect of Canada's tax and transfer systems. This ambivalence derives from the basic conceptual change implicit in the fundamental reform option: the explicit integration of income-tested transfers with the personal income tax system, with one being the negative of the other.

Finally, the two options are assessed briefly with reference to the original objectives and constraints set out to guide their design.

Background and Context

As noted in the Foreword, in the last several years, there has been an increasing number of proposals put forward for a guaranteed income.[1] In the mid-1970s, the basic document was the Orange Paper (1973) that launched the Social Security Review (SSR). This

federal-provincial consultative process failed to achieve any significant reform. However, it was notable at least for its emphasis on one major conceptual innovation, the idea of two distinct guaranteed income tiers, one for those unable or not expected to work – the income support tier – and one for everyone else, particularly the working poor – the supplementation tier. This idea of a two-tiered guaranteed income has apparently been accepted widely among analysts and commentators concerned with the issue. In addition, the SSR was notable for the range of options considered with respect to the federal-provincial division of financing and delivery responsibilities.

With the failure of the federal-provincial route to income security reform in the SSR, reform-minded elements of the federal government turned to the only other possible vehicle and one that would allow unilateral federal action – the personal income tax system. Under the aegis of the Department of Finance, an interdepartmental task force on tax-transfer integration in 1977 looked to the personal income tax system as the vehicle for delivering what would be the supplementation tier portion of a guaranteed income system.[2] The task force could find no particular technical problems with the notion of negative taxes or, as they are now called, refundable income tax credits. This blessing of the idea by a group consisting mainly of Treasury Board and Finance officials helped set the stage for the Child Tax Credit introduced in 1978.

At the provincial level, the failure of the SSR led several provinces to move ahead on their own to develop various income supplementation programs, particularly Manitoba, Saskatchewan, and Quebec.

From the late 1970s to the early 1980s, there was a hiatus in the public debate about a guaranteed income. In the mid 1980s, however, three major reports were published, the Quebec White Paper (1984) and the reports of the Macdonald (1985) and Forget (1986) royal commissions. All these reports call for major restructuring of the income security system, including the creation of a new income supplementation tier. The Parizeau report (Quebec White Paper on the Personal Tax and Transfer Systems) is particularly notable for its concern about the poverty trap – the very high effective marginal tax rates faced by the poor as they attempt to work themselves out of poverty. As well, there is a deliberate attempt to harmonize the income tax and income transfer systems, for example, to ensure that transfer recipients would not have to pay income tax, to use common definitions of the family unit and of income, and to index both systems in the same way over time.

The Macdonald royal commission suggested major reforms in the income transfer area. Their proposed federal Universal Income Security Program (UISP) is akin to the SSR supplementation tier and was motivated in part by the objectives of improving equity and incentives, targeting benefits to those most in need, particularly the working poor, and rationalizing the income security system. The UISP would be financed by abolishing or cutting back many existing income transfer programs as well as a number of tax expenditures. In fact, some of the intellectual heritage of the UISP can be traced to ideas percolating in the now defunct Ministry of State for Social Development in 1984. While that thinking had clearly identified the need to integrate reforms of the income security system, such as a UISP, with reform of the personal income tax system, the Macdonald

commission for some reason chose to ignore this. As a result, Wolfson (1986) has argued that their UISP proposal is seriously flawed.

Most recently the Forget commission (1986), while focusing on the Unemployment Insurance program as directed by their terms of reference, also proposed the creation of a new national income supplementation program. Indeed the Forget report is notable for the careful development of an argument distinguishing three tiers in the income security system: income support, income supplementation, and social insurance. In their view, most of UI is social insurance, but regionally extended benefits in particular should be viewed as a form of income supplementation rather than social insurance. This argument underlies their proposal to abolish these particular earnings- and region-related UI benefits and replace them with a more explicit form of income-tested supplementation program with benefits related to the size of the family.

Unlike Macdonald, Forget appears to have adopted a perspective more sensitive to provincial governments' concerns. The Forget supplementation program, while national in scope, would be tailored to each province's specific requirements in consultation with the government of the province in question. Forget also recognizes the importance of at least harmonizing these supplementation programs with the personal income tax system. However, perhaps because of the added complexities of provincial variations in supplementation programs, as well as the recognized need to take account of the personal income tax system, no specific option for the supplementation tier was presented. This may prove unfortunate, because much of the criticism of the Forget proposals to cut UI centres on the fact that the proposed cuts are detailed precisely while any new programs to offset the UI cuts, particularly the income supplementation program, are not.

Finally, the current context for debating reform of the tax and transfer systems must include the major reforms of the U.S. income tax system just passed into law and their reverberations in Canada, where the Minister of Finance has indicated that major tax reform is being contemplated. The U.S. tax reform has made the concept of a flat tax much more popular and has opened the possibility of major shifts between tax bases, in particular, by lowering personal and raising corporate income taxes. Perhaps more important, recent U.S. tax reforms by their example may have put in question the conventional Canadian wisdom that reform must be incremental.

Objectives and Assumptions

As noted at the outset, this paper presents two specific options in order to provide the basis for a more concrete discussion of income security reform. Both options move in varying degrees toward a guaranteed income. However, before turning to the development of these reform options, it is important to place some bounds on the discussion. Social and tax policies are both broad areas and this analysis touches only a portion of each. Major social policy programs include health care, education, housing, social services, job creation and training, social insurance (UI, C/QPP, OAS and workers' compensation), and other income transfers. In the main, the last group of social programs will be considered here. In the case of tax policy, the focus will be on the personal income

tax system, particularly tax credits, personal exemptions, and tax rates. However, many other personal income tax policy issues, like the definition of net income, will not be considered. Essentially, the focus is on the income support and supplementation parts of the tax and transfer or income security systems. Important areas of social and public policy such as housing, employment, social services and social insurance are generally not considered, even though there are often important linkages. For example, the very high implicit marginal tax rates in some housing and day care subsidy programs have not been taken into account in this analysis.

One of the main lines of criticism of guaranteed income proposals derives from the view that people should earn their income from work. It is widely thought to be better for people to gain their income from being productive contributing members of society rather than to receive it as a handout from the state. Politically or ideologically, there may be some merit to the argument that having in place a reasonable guaranteed income would reduce pressure on the government of the day to strive for full employment. However, it may be a bit harsh to argue against more adequate basic income guarantees because they might make it easier politically to allow high unemployment rates to persist.

Another variant of this argument against a guaranteed income is that it would divert scarce government funds from job creation or other employment initiatives. The strength of this argument depends on the comparative likelihood that employment policies such as public sector job creation, work sharing, and wage subsidies would work more effectively. For example, "make work" projects might not give employees any greater sense of self-worth than a guaranteed income.

At a more technical level, it may be argued that there is a conflict in design between employment policies such as work-sharing or wage subsidies and income transfer policy. However logically, it is just as possible to follow fiscal, job creation, wage subsidy, work-sharing or other policies directed toward reducing unemployment with or without a guaranteed income in place. For example, if a wage subsidy program were introduced with a guaranteed income already in place, the wage subsidies could be treated just like other employment income and thus be partially taxed back under the guaranteed income program. In fact the costs of the wage subsidy program, net of the savings in guaranteed income payments, would be reduced.

More broadly, as Thurow (1980) has argued, it may be easier to pursue various adjustment or restructuring policies leading to higher economic growth and employment if there is a more adequate and smoothly functioning income security system in place. The key point is that the elaboration of options to reform the income tax and transfer systems should not be seen as an alternative to policies designed to generate employment; these options could just as well be complementary.

A Tale of Two Options

From some viewpoints, Canada's tax and transfer systems are fraught with problems. For example, current concerns include the view that the basic incomes provided to the needy are inadequate, that high effective marginal tax rates are stifling personal initiative, that

something must be done to these programs to reduce the deficit, that the whole system is too complex, that women are penalized by 'man in the house' and similar rules in the social assistance system and by the dependency implied by the marital tax exemption, and that the well-off are not paying their fair share of taxes. Developing a policy option to address any one of these concerns runs the serious risk of making things worse for some of the other concerns. The options developed in this paper seek to address all these kinds of concerns simultaneously. This task is clearly much more difficult. One corollary is that major progress on any one concern is unlikely. Instead, it may only prove feasible to make modest progress in a few of these diverse areas while holding the line in others.

As a result, the two options presented in this paper are by no means finished products. They are exploratory, designed to provoke and focus discussion.

In endeavouring to construct these options for tax and transfer reform, one of the first conundrums relates to federal-provincial interactions. The federal government's room for unilateral action is limited; but broader action requiring federal-provincial negotiation may be so long and drawn out that nothing would ever happen. Politically, small unilateral federal reforms have the greatest chance for successful implementation. However, there are technical obstacles because of the way most provinces (all but Quebec) piggyback their personal income taxes on top of the federal tax system under the Tax Collection Agreements. When the federal government cuts back a tax expenditure like the child tax exemption, revenue windfalls are generated for the provinces, and less money is available to redirect toward a more targeted provision like the child tax credit. In turn, this results in too many prospective losers from the reform option, as well as a reluctance on the part of the federal government to cut back those tax expenditures that will result in provincial revenue gains.

Another Catch-22 concerns UI. All three recent royal commissions that studied UI – Macdonald (1985), Forget (1986), and House (1986) in Newfoundland – raised serious concerns and suggested scaling back UI benefits. But they also all recognized that such reform of UI cannot be done in isolation; some package of new benefits to offset major losses by individuals and regions is essential. All three recommended some form of guaranteed income (though in Macdonald's case the proposed guaranteed income was not funded by any of the proposed UI cuts). But this implies that the minimum package for UI reform must also include a major new program, a guaranteed income. In turn this minimum package may have become too large to be politically feasible. To make matters worse, as already argued by Parizeau (1984) and Wolfson (1986), no sensible guaranteed income is feasible without considerable reform of the personal income tax system; thus the 'minimum' reform package becomes even more sweeping and hence politically indigestible.

What to do? To see whether there is a way out of the Catch-22s, conundrums and competing concerns just described, two options will be defined. The first follows a federal strategy of piecemeal incremental unilateral reform as far as possible, building upon the current federal government's stated objectives for social policy reform. The second, almost polar opposite, option is premised on sweeping integrated reforms of both federal and provincial tax and transfer programs. To give both options names that reflect their

positive as well as their negative attributes, we refer to the first option as "modest tinkering" (MT) and the second as "profound demolition" (PD).[3]

Both options take as their starting point the four objectives enunciated by the federal Minister of Finance in the February 1986 budget:

- maintain universal access,
- direct more resources to those most in need,
- improve the opportunities for individuals to become more self-reliant, and
- reduce the after-tax value of benefits going to higher-income Canadians.[4]

It is assumed that self-reliance is improved by restructuring the income tax and transfer systems to increase incentives to work and to save; in turn, this would seem to imply a reduction in marginal tax rates. Universal access presumably means universal delivery, which does not preclude universally delivered benefits like OAS and Family Allowance from subsequently being fully or partially taxed back from the affluent. Finally, directing more resources to the needy while cutting back on benefits to the well-off clearly calls for more redistribution from rich to poor.

The two options also accept the constraint that they be fiscally neutral for both the federal government and each provincial government (that is, that the net value of revenues minus expenditures for the taxes and programs altered or replaced by the reforms remain unchanged). This assumed fiscal neutrality is arbitrary and may in the end be impolitic. Recent U.S. tax reform experience and subsequent federal announcements regarding the broad thrust of Canadian tax reform illustrate the apparent political benefits of packages that draw upon increased revenues from corporate or sales taxes to provide income tax cuts for households. However, for purposes of an initial analysis exploring the trade-offs between incremental and sweeping reform, the assumption of fiscal neutrality serves a useful role by preventing the discussion from becoming even more complex.

Beyond these common policy objectives and constraints, the two options diverge. The modest tinkering option adopts no further objectives; rather it accepts a further set of constraints:

- no major changes to existing programs,
- no losers in the lower- and middle-income ranges,
- all changes can be implemented by unilateral federal action, and
- the changes can be implemented in a sequence of small steps.

In contrast, the profound demolition option accepts no further constraints. Instead, it attempts to meet a more ambitious set of additional objectives:

- a major simplification of the income tax and transfer systems to make them easier to understand and administer,
- provide basic income guarantees that are adequate in some generally accepted sense, and
- a design that is neutral to a variety of alternative behaviours like marriage and divorce, income splitting, and income averaging.

The last neutrality objective has a number of aspects. From the viewpoint of family composition, it would mean, for example, that a household consisting of two adults and two children would be treated exactly the same by the tax/transfer system, regardless of whether that household represented itself as a married couple with two children, two single parents each with one child, or one single parent with two children plus an unattached individual. In the case of a dollar of income, neutrality would obtain if that income had an identical impact on a household's net tax/transfer position irrespective of the source of the income, who in the household received it, and whether it was received this year or next. Neutrality is thus a powerful objective, particularly in terms of potential simplification and the removal of possibly perverse behavioural incentives from the tax and transfer systems. However, as will be seen, it has some significant costs when compared to the current system.

Given these differing objectives and constraints, the two options can be viewed as polar extremes for a range of options, a spectrum of policy initiatives that illustrate in particular the trade-offs between ease of implementation and the potential for substantial improvements in the simplicity, adequacy and neutrality of the income tax and transfer systems.

The MT Option in More Detail

Table 1 gives an overview of the two options, focusing on their broad design features. Total taxes and benefits over a year are the primary interest; issues relating to such aspects as monthly delivery will be discussed later.

The basic strategy of the MT option is to cut back a number of federal programs and tax expenditures, then redirect the monies thereby freed up to enrich the newly introduced refundable sales tax credit. This federal tax credit would then become an embryonic guaranteed annual income. However, to pursue this strategy unilaterally, the federal government would have to choose a set of program and tax expenditure cuts carefully designed not to create any net provincial revenue windfalls or losses.

To achieve this latter objective, the MT option first requires changes that reduce the federal income tax base and hence, via the Tax Collection Agreements, provincial income tax revenues.[5] These changes then allow scope for selected tax expenditures to be cut, thereby increasing the tax base up to the point where the provinces are left in close to a fiscally neutral position. Finally, federal monies generated by the first two tactics are redirected toward an enrichment of the new refundable sales tax credit.

TABLE 1: Overview of MT and PD Options

Program	Program Changes Under Two Options	
	Modest Tinkering (MT)	Profound Demolition (PD)
Family Allowance (FA)	• cut to $300 • high-income tax-back	• abolish
Child Tax Exemption	• cut (same $ amount as FA)	• abolish
Child Tax Credit	• no change	• abolish
Old Age Security (OAS)	• make non-taxable • high-income tax-back	• make non-taxable
Guaranteed Income Supplement (GIS)	• cut by amount of sales tax credit increase less $10	• abolish
Provincial GIS Top-Ups	• no change	• no change
Age Tax Exemption	• abolish	• abolish
Pension Income Deduction	• abolish	• abolish
Marital Exemption	• cut by $300	• abolish
Other Personal Exemptions	• no change	• abolish
Canada Assistance Plan	• no change	• abolish • new 100% provincial support program
Unemployment Insurance	• cut 10%	• cut 30% • abolish premiums
Sales Tax Credit	• increase subject to fiscal neutrality	• abolish
Income Tax Rates	• no change	• flat rate plus minimum tax for top 10%
Federal Income Supplementation	• yes, via sales tax credit	• yes, universal

It must be emphasized that the MT option has not been constructed necessarily to represent a reasonable package of reforms. Rather, it reflects an attempt to come up with the best package according to the constraints and objectives set for it, as well as the kinds of policy options that have been the subject of recent public discussion. It is intended to combine several strands of thinking in one option so their joint impact can be examined.

The cuts in the provincial income tax base that also yield savings to the federal government would start with the Family Allowance. It would be cut back by about $80 per year (all figures are expressed in 1986 dollars) to $300 per year. In addition, at income tax time, the Family Allowance would be taxed back at a rate of 5 per cent from families with a combined net income (husband plus wife) in excess of $45,000. This amounts to almost a 25% cut in the Family Allowance. While part of the modest tinkering option, this step is intended to represent the outer limits of the kinds of changes speculated upon by the media in the summer of 1986.

The next major change in the tax base would be to make OAS non-taxable. In addition, a tax-back would be instituted along the same lines as for the Family Allowance, but at a rate of 10 per cent on a couple's combined net income in excess of $30,000.

Finally, it is assumed that UI benefits would be cut by 10 per cent (modelled simply as a proportionate cut in benefits). This is certainly a controversial move in a period of high unemployment, but also a relatively small cut compared to those recommended by Forget and Macdonald.

These cuts in direct federal expenditures and the removal of income tax on OAS would reduce provincial income tax revenues. The federal government would then have the option to cut a number of tax expenditures such that, on balance, provincial revenues would be generally unchanged. Thus, the MT option would also cut the child tax exemption (in respect of children under age 18) by the same $80 per year as Family Allowance, and the age exemption and $1,000 pension income deduction would both be abolished. It turns out these cuts in tax expenditures, when coupled with the FA and UI cuts and change in the taxability of OAS, still leave the provinces with some net revenue gains. Thus, to make the final package neutral in its fiscal effect on the provinces, the marital exemption would be cut by $300. (This latter change is in line with the Royal Commission on the Status of Women (1970) recommendations. The $300 figure was solved for by simulation.)

The federal monies saved by all these changes would be used to increase the refundable federal sales tax credit ten-fold, from $50 to $500 per adult and from $25 to $250 per child per year. The refundable sales tax credit would be increased instead of the refundable child tax credit for two reasons: first, it is more highly targeted to the low end of the income spectrum and second, it is payable to adults as well as children and thus would constitute the beginnings of a national guaranteed income. On the assumption (which should certainly be the subject of debate) that programs for the non-elderly poor are less generous than those for the elderly poor, all but $10 of the sales tax credit increase would be offset for the elderly via a $440 per person reduction in the basic guarantees under the Guaranteed Income Supplement.

This package of changes is already fiscally neutral for the provinces. In order to keep it fiscally neutral for the federal government, the phase-out or income-testing of the sales tax credit would have to start when a couple's combined net income reached $8,000 rather than the current $15,000, and the tax-back rate would have to increase from 5 to 10 per cent.

The PD Option in More Detail

In contrast to the MT option, the profound demolition option is a complete departure from the status quo – at least in structure and appearances.[6] (As we shall see, in terms of overall income redistribution, it is not that great a change.) As shown in Table 1, the PD option would abolish much of the current income tax and transfer systems and consolidate many programs. Since the current system is so complex, such major restructuring is the only way to achieve any significant simplification and something much closer to neutrality.

Perhaps the most radical change in the PD is conceptual. There would no longer be any difference at the federal level between income transfers and income taxes; both would be part of the same integrated system. Taxes would be seen as negative transfers and vice versa. In turn, the arbitrary accounting distinction between the child tax credit and GIS, for example, would disappear. Why should one provision appear in the public accounts and be placed before Parliament each year for explicit approval while the other is not?

Juxtaposing taxes and transfers this way highlights the difference between net and gross dollar flows between governments and households. For example, of the roughly $35 billion in personal income and payroll taxes collected by the federal government in 1984, about 90 per cent was accounted for in expenditures on the transfer programs being analysed. This leads to a related major conceptual change embodied in the PD option: the primary objective of an integrated personal income tax/transfer system is redistribution. There is no longer the traditional split between a tax system whose primary objective is to raise revenue for government and an expenditure system one of whose major roles is redistribution.

These conceptual changes are perhaps larger than the practical changes in delivery systems. Under the PD option, many families would both receive monthly cheques – they could be called refundable tax credits or universal demogrants – and have taxes deducted at source from their paycheques. This situation already exists for Family Allowance, OAS, GIS and refundable tax credit cheques, and the payment of income tax after year end. However, most people still do not view GIS, let alone OAS and the Family Allowance, as potential parts of the same system that withholds income tax at source.

Given these conceptual changes, the PD option embodies a number of basic strategies. The objectives of simplicity and neutrality are achieved by having a basic flat rate of tax applicable to the majority of families, as well as a system of annual income guarantees that depend generally on age and not, for example, on marital status. The concept of harmonization of provincial and federal taxes is retained by assuming the

provinces would continue to piggyback their personal income taxes on federal tax as at present.

At the same time, a form of federal-provincial 'disentanglement' is assumed regarding the Canada Assistance Plan, which funds provincially delivered social assistance. The income-tested transfer portion of the system would have two parts – a support tier for those unable or not expected to work, and a new supplementation tier oriented primarily toward the working poor. The federal government would have full responsibility for the new income supplementation tier, which would be part of an integrated tax/transfer system, while the provinces would have full responsibility for an income support tier stacked upon the federal system. This disentanglement would replace explicit 50/50 federal-provincial cost-sharing of existing income support programs under the Canada Assistance Plan with implicit cost-sharing: the federal government would pay for 100 per cent of supplementation benefits, and the provinces would pay for 100 per cent of support benefits. The needy who now receive jointly funded social assistance would instead receive both provincial support and federal supplementation benefits.

Finally, the views of the three recent royal commissions that have examined the UI program would be accepted in the sense that the PD option incorporates a 30 per cent cut in UI benefits (simulated as a simple proportionate cut). Implicitly, the monies would be reallocated from a social insurance role (that is, benefits based on previous levels of individual earnings) to a new income supplementation program (with benefits based on family size and total income).

A major objective of the PD option is to try to provide adequate income guarantees within the limits of reasonable marginal tax rates. The PD option can be viewed as one point on the trade-off curve between the level of basic income guarantees and the taxes needed to finance them.[7] It is left to the reader to judge whether the particular combination of parameters errs too much toward keeping tax rates low and providing stingy income guarantees. What is most important to realize is that it is not possible to have both higher income guarantees and lower personal income tax rates.[8] Thus, the PD option is worth pondering when one considers whether Canada can afford an adequate guaranteed annual income.

Because the PD option involves such fundamental changes, it is easier to explain its essential features directly rather than comparing them to the status quo. Overall, the PD option would provide a basic guaranteed annual income for a couple with two children of $16,200 if neither spouse were able or expected to work. The guarantees would be coupled with a simple flat-rate income tax with no personal exemptions. Those two elements – basic income guarantees and a flat-rate tax – are the core of the PD option.

To start, the PD option would provide basic federal income guarantees of $2,640 per non-elderly adult and $960 per child (under age 18) per year. The guarantees for the elderly would be $3,500 per person plus $720 per year for elderly people living alone. Because they include a special 'living alone' allowance, the benefits for the elderly are not as simple as those for the non-elderly. They are also non-neutral insofar as they depend on a definition of living alone. However, something like this is required to mimic the current GIS benefit structure, which is also non-neutral because it depends on marital

status. In this area, the PD option has erred on the side of retaining the non-neutrality of the GIS via a living alone benefit, albeit in lieu of a direct dependence of benefits on marital status. The alternatives required to achieve neutrality (i.e., benefits for couples equal to exactly twice the benefits for a single person) would have been at the cost of either providing extra benefits for elderly couples or making the single elderly worse off. (Also, given the minimal numbers of common law unions among the current elderly or soon-to-be elderly, particularly compared to younger generations, it may be some decades before the financial incentives for the retired to enter into common law unions begin to have an impact.)

By themselves, these federal guarantees are not intended to provide adequate incomes for the non-elderly. They would provide an income supplementation tier whose largest relative impact is intended to be for the working poor. The provinces would then piggyback additional guarantees so that their top-ups would make up the support tier. The provincial support guarantees would be conditional on some test of employability, for example, based on disability, single parenthood, or high local unemployment rates. When combined with federal supplementation guarantees, these support guarantees would produce an adequate guaranteed minimum income for those Canadians not able or expected to work.

The provincial support guarantees assumed in this analysis would be identical for all provinces. They would be higher than the federal guarantees for the non-elderly: $3,000 per year for those aged 18 to 64 and $1,500 for children under age 18. These income support guarantees would be subject to a 40 per cent provincial tax-back rate on total family income. This income testing would be stacked on top of the basic federal and provincial income tax rates (see below). The provincial support guarantees would be available only to non-elderly families unable or unexpected to work. The elderly would not be eligible because the federal OAS is retained. However, the existing top-ups some provinces add to GIS are assumed to remain essentially unchanged. (Of course, in practice, the provinces would be free to tailor their support programs any way they wanted.)

For purposes of the numerical simulations presented below, receipt of any social assistance benefits was used as a proxy for being unable or not expected to work. Thus, the PD option simulation reduces to zero all social assistance benefits and instead gives these households a provincial support benefit based on the number of non-elderly adults and children and a 40 per cent tax-back rate.

Given these basic guarantees, all net income (generally as defined in the federal *Income Tax Act*) would be taxed at a basic rate of 29.5 per cent. This rate of tax would apply to the first dollar of income; there would be no personal exemptions. This flat rate of tax folds in UI premiums; the UI payroll tax would be abolished and the UI program would be funded completely from general federal revenues. Alternatively, the UI payroll tax could be thought of as being reformed first by broadening the base from earnings to all income and then by removing the maximum on contributions.

To retain something like the existing degree of progressivity in the current ten-bracket income tax rate structure, there would also be a surtax cum minimum tax. This

tax would be at a rate of 16.5 per cent and would apply to total income – that is, net income plus various incentive and tax preference deductions – in excess of $40,000. (This structure is patterned after the Bradley-Gephardt proposal in the U.S. tax reform discussion of 1985.) Thus, on net income over $40,000 the marginal federal tax rate would be 46 per cent (29.5 per cent plus 16.5 per cent), while deductions like those for RRSP contributions and charitable donations would be subject to a 16.5 per cent minimum tax to the extent an individual's total income exceeded $40,000. (Implicitly, incentives and tax preferences have been converted from deductions to refundable tax credits.)

Federal guarantees and taxes would operate purely at the individual level. Women would be treated as individuals and, unlike the current system, would never be taxed at their husbands' marginal tax rates when they entered the paid labour force. One major exception is that investment income of parents and minor children would be aggregated and taxed in the hands of the family member with the highest income. This removes any incentives for splitting investment income within the nuclear family, though incentives for splitting employment income and for generation-skipping investment income splitting (i.e., with grandchildren) would remain.

It should be noted that the abolition of UI premiums and the aggregation of investment income in the family are not fundamental to the PD option. Each has its pros and cons. Both would improve the equity and fairness of the PD option. The abolition of UI premiums would also simplify the system and remove the fiction that UI premiums are like private insurance premiums – where premiums bear some reasonable relationship to actuarially expected benefits. The aggregation of investment income for higher-income families would make the tax return somewhat more complex, but it would also eliminate much of the current complexity of the *Income Tax Act* relating to the attribution rules.

The investment income aggregation also introduces non-neutrality with respect to marital status, because there would be a financial incentive for higher-income couples with investment income to live in a common law union rather than a legal marriage. A similar and indeed greater non-neutrality arises from the joint income testing of the provincial income support guarantees and the 40 per cent tax back on a couple's combined income. The reader may wish to consider this a form of vertical equity: if non-neutrality of this sort is acceptable for the poor, then it should be acceptable for the well-off.

The 29.5 and 16.5 per cent tax rates and the basic federal income supplementation guarantees just described are fiscally neutral for the federal government, given the cuts and abolition of programs and tax expenditures set out in Table 1. For the provinces to be left in a fiscally neutral position as well, they are assumed to piggyback their personal income taxes on basic federal tax, i.e., federal tax at the 29.5 per cent basic rate plus the 16.5 per cent surtax cum minimum tax on income over $40,000 *before* any federal guarantees. Given this much broader federal base, fiscally neutral provincial rates expressed as a percentage of basic federal tax can be about half as much as at present, as shown in Table 2.

As already described, those receiving provincial income support would have their provincial benefits income tested at a 40 per cent rate. This 40 per cent tax-back rate would be stacked on top of the basic federal plus provincial income tax rates, yielding

effective marginal tax rates in the range of 75.9 to 77.5 per cent. This is somewhat lower than the 100 per cent effective marginal tax rates generally applicable under current provincial social assistance programs. By design, these high marginal tax rates would apply in cases where the recipients are unable or not expected to work. But lowering the rate from 100 per cent to the 77 per cent area would provide at least some incentive, for example, to a single parent or disabled person who still wished to seek employment.

TABLE 2: Marginal Income Tax Rates by Region and Income Level

Province	Provincial Tax Rate on "Basic Federal Tax"	Combined Federal Plus Provincial Rate	
		below $40,000	above $40,000
	%	%	%
Atlantic[a]	26.7	37.4	58.3
Quebec[b]	45.9	35.9	56.0
Ontario	23.3	36.4	56.7
West[a]	23.3	36.4	56.7

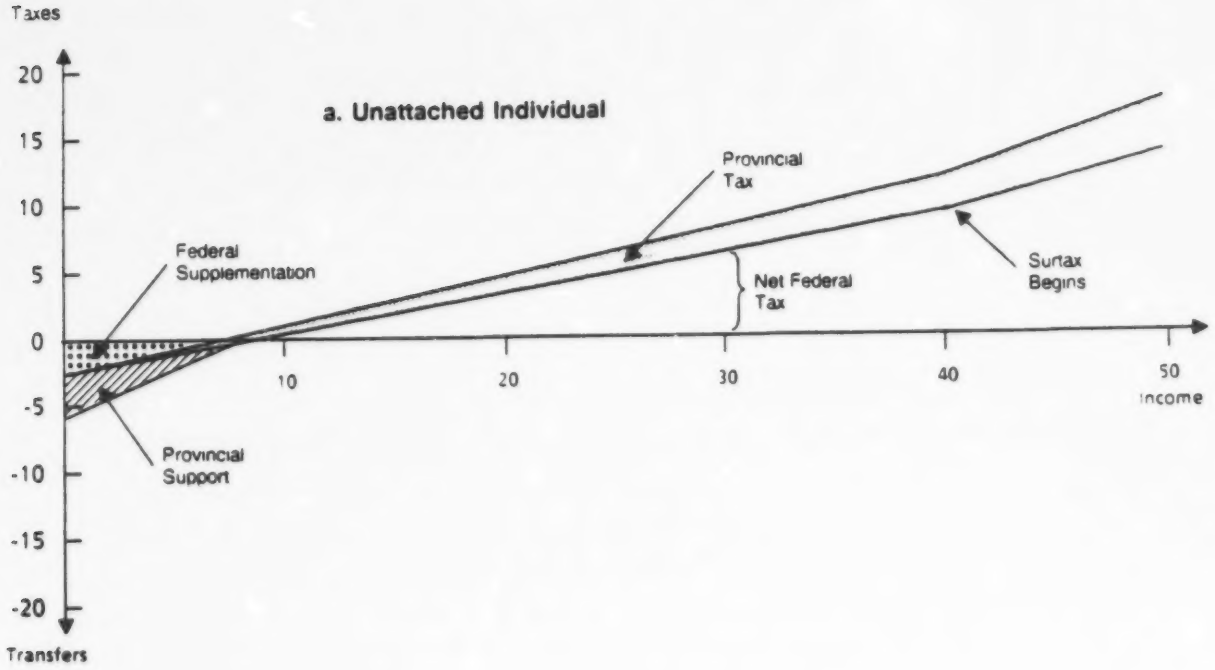
Notes: a. Weighted average.
b. Assuming federal basic tax reduced by 16.5 per cent to reflect the Quebec abatement.

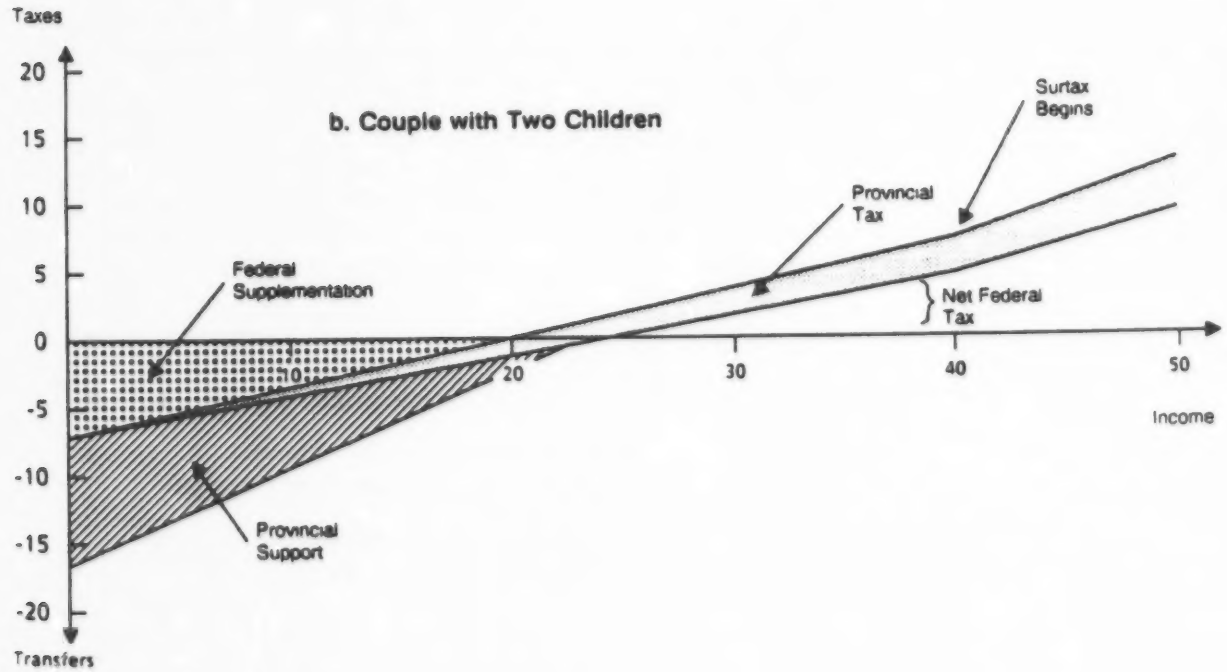
The major elements of the tax/transfer structure under the PD option are illustrated in Figure 1. The basic linear structure of the PD is clearly evident. There is a flat-rate tax except at the bottom of the income range where some families may also be eligible for provincial support, and at higher incomes where everyone would be subject to the surtax cum minimum tax. These graphs show net benefits or taxes in relation to income. Depending on the details of the delivery system, gross dollar flows would likely be greater as monthly cheques were sent out during the year and the final tax/transfer reconciliation occurred the following spring at income tax time.

One point that is clearly evident from the graphs is that the amount of the federal guarantees does not matter only for the poor. Changing basic federal guarantee levels would move the basic tax/transfer schedule up or down in parallel for everyone along the entire income spectrum. Thus, middle- and upper-income groups would have a stake in the basic level of federal guarantees. This would be exactly analogous to the "middle class solidarity" seen as an advantage by many for the current universal demogrant programs, Family Allowance and OAS.

Figure 1

Illustrative PD Tax/Transfer Schedules ($000's)





Trade-offs in the PD Option

There is a wide range of variants on the PD option that would have the same basic structure and be fiscally neutral. How was this particular variant chosen? In the context of the basic objectives, several more specific concerns were balanced:

- the combined federal and provincial guarantees should come close to being adequate;
- the basic federal marginal tax rate should be less than 30 per cent;
- the top federal plus provincial marginal tax rate should not be above current rates, which are in the range of 50 to 60 per cent;
- the surtax cum minimum tax should not affect more than about 10 per cent of the population;
- at least 50 per cent of the population should gain;
- the top marginal rate for the provincial support tier should come down toward 75 per cent; and
- the basic guarantees for the elderly should not be increased, but their marginal tax rates should come down.[9]

For the federal government, the starting points were the 29.5 per cent basic tax rate and the 16.5 per cent rate and $40,000 threshold for the surtax cum minimum tax. Then basic (non-elderly) adult and child guarantees were sought in the range of $200 and $100 per month respectively. A pair of guarantees that would leave the federal government fiscally neutral was chosen: $2,640 per adult and $960 per child per year.

Several trade-offs within the ambit of fiscal neutrality were simulated. One possibility is to lower both federal tax rates and basic federal supplementation guarantees. Another is to hold tax rates fixed but increase guarantees for children by reducing guarantees for non-elderly adults (on a roughly $2 for $1 basis). However, both these strategies reduce the overall proportion of people who would gain by moving from the status quo to the PD. On the other hand, lowering the basic federal tax rate and increasing the surtax rate (on a roughly 7.5 to 1 basis) tends to increase the overall proportion of gainers (by lowering taxes broadly in the middle-income ranges and raising taxes for the minority in the upper-income ranges who are subject to the surtax).

Another way to view the trade-offs is in financial terms. Every billion dollars can, in the context of the PD option, finance:

- a $65 per annum increase in the basic federal non-elderly adult guaranteed income;
- a $145 per annum increase in the basic federal child guaranteed income;
- an 0.4 percentage point cut in the basic 29.5 per cent federal tax rate,

- a three percentage point cut in the 16.5 per cent surtax cum minimum tax rate, or
- a $6,000 increase in the $40,000 surtax threshold.

These figures are relevant, for example, if the PD option were to be combined with a net federal sales or corporate income tax increase.

For provincial governments, the starting points were the 40 per cent tax-back rate and the $3,000 and $1,500 basic income support guarantees for non-elderly adults and children respectively. Note that these guarantees are assumed to be payable only to people living in families that had received social assistance, as a proxy for being unable or unexpected to work. Provincial tax rates on basic federal tax were then determined, with the results shown in Table 2, to assure fiscal neutrality in each of the four geographic regions, given provincial savings from the abolition of CAP. In this specific context, an extra billion dollars of provincial expenditure on the support tier would finance a combined increase of roughly $650 in the adult support guarantee and $325 in the child support guarantee. Correspondingly, a one percentage point tax rate increase in each of the four geographic regions would correspond to revenue gains of about $50 million, $180 million, $335 million, and $270 million for the Atlantic region, Quebec, Ontario, and the West respectively.

These fiscal results and the more detailed figures in the following sections of the paper are derived from a large number of computer simulations using the Volksmodel, a software and database tool (see below).

Adequate Minimum Incomes

The combined federal supplementation and provincial support guarantees in the PD option just outlined amount to $5,640 per non-elderly adult and $2,460 per child under age 18. Are these amounts adequate to live in Canada? This is clearly a contentious question. Instead of answering it directly, we shall review the answers given by a range of current sources:

- the quasi-official federal view implicit in Statistics Canada's low-income cut-offs (LICOs),
- the front line or social worker's view as reflected in some of the poverty lines developed by social agencies,
- provincial politicians' views implicit in current social assistance benefit levels, and
- federal politicians' views as revealed by OAS/GIS guarantees.

Table 3 presents the basic figures for the Statistics Canada LICOs, poverty lines defined by three social agencies, and the guarantee levels proposed in the PD option. (The MT option cannot be shown because it varies so much with the particular circumstance of

the family.) Typically, the first two family members are assumed to be adults and subsequent family members to be children. However, a three-person family could also be a single parent with two children. The first row of percentage figures shows the ratios of the low-income or poverty lines for those family sizes to the corresponding figures for a one-person family. The second row of percentages in the columns for family sizes 2 to 5 shows the difference between the ratio immediately above and the one for the family size one smaller. These ratios and percentages will be used to discuss the relative needs of different types of families.

TABLE 3: Low-Income Cut-Off and Poverty Line Levels ($) and Relativities (%) by Family Size

Agency	Family Size				
	1	2	3	4	5
Statistics Canada LICO (urban size 100,000 to 500,000)	$10,245 100%	$13,506 132% 32%	$18,042 176% 44%	$20,849 204% 28%	$24,205 236% 32%
Canadian Council on Social Development	9,684 100%	16,141 167% 67%	19,368 200% 33%	22,596 233% 33%	25,824 267% 34%
Metro Toronto Social Planning Council	13,040 100%	17,406 133% 33%	22,292 171% 38%	26,658 204% 33%	30,944 237% 33%
Montreal Diet Dispensary	6,040 100%	8,645 143% 43%	11,075 183% 40%	13,070 216% 33%	14,943 247% 31%
PD Option (including provincial support)	5,640 100%	11,280 200% 100%	13,740 244% 44%	16,200 287% 43%	18,660 331% 44%

Source: 1986 figures derived from the Metro Toronto Social Planning Council's "Social Infopac" (September 1983) figures for 1983 (Tables 1, 2, 4 and 5) inflated by the CPI (13.1%) to 1986.

Table 4 shows provincial social assistance and other benefit levels for four different types of families. These appear to be the only figures readily available in the public domain assembled on a comparable basis across provinces.[10] Here, the percentage figures

are the ratios of benefit levels to the corresponding figures for single disabled persons. Again the PD option is shown for comparison; the MT option is simply the supplemented social assistance figures shown plus $425 per adult and $225 per child (i.e., the amount of the increase in the refundable sales tax credit).

TABLE 4: Supplemented[a] Provincial Social Assistance Benefit Levels ($) and Relativities (%) by Region and Family Type

Family Type	Atlantic[b]		Quebec		Ontario		West[b]		PD	
Single, Employable	$4,056	65%	2,158	38%	4,905	72%	5,025	72%	2,640[c]	47%
Single, Disabled	$6,199	100%	5,652	100%	6,789	100%	6,991	100%	5,640[d]	100%
Single Parent, one child	$8,718	141%	8,336	148%	9,210	136%	9,254	132%	8,100[d]	144%
Couple, two children	$11,628	188%	11,755	208%	11,469	167%	13,952	200%	16,200[d]	287%

Notes: a. Provincial social assistance plus Family Allowance, child tax credit, provincial credits and other supplements.
b. Atlantic and West are simple averages of individual provincial figures.
c. Federal guarantee only.
d. Federal plus provincial guarantees, i.e., not able or expected to work.

Source: 1986 figures derived from the Metro Toronto Social Planning Council's "Social Infopac" (March 1986) figures for 1985 (Tables 5 and 6) inflated by 4 per cent to 1986.

Let us start with single unattached adults. From the low-income and poverty lines (Table 3), the basic minimum income requirement varies by a factor of over two, from $6,000 to $13,000. Taking a single disabled person as indicative of someone who is unable and not expected to work, the provincial social assistance benefit levels imply basic minimum needs in the range of $5,600 to $7,000 (Table 4). Finally, drawing on federal politicians' perspectives, federal OAS plus GIS benefit levels for a single individual were $7,667 in 1986. In contrast, the combined federal and provincial guarantee in the PD option for a single person unable or not expected to work is $5,640. This is at the low end of the range of figures cited.

Turning next to children, we see from the low-income or poverty lines that an extra person (after the second in a family, i.e., the last three columns of Table 3) adds to basic

needs the equivalent of 28 to 44 per cent of the amount required for the first adult. In absolute terms, this is from $1,900 to $4,500 per child, assuming the third and subsequent family members in Table 3 are children. The relative patterns implicit in the social assistance benefit levels are similar. Comparing a single parent with one child to a single disabled person, the child adds from 32 to 48 per cent to basic income requirements. In absolute dollar terms, the first child adds from $2,300 to $2,700 in social assistance plus Family Allowance and the child tax credit. Since the PD option would provide $2,460 per child to families eligible for provincial support as well as federal supplementation, the benefits would be at the low end of the low-income and poverty line ranges and in the middle of social assistance ranges in absolute dollar terms; they would be high in relative terms, however, at 44 per cent of the benefits for a single adult.

The PD option effectively imposes a 53 per cent penalty on adults for employability – in other words, loss of the $3,000 provincial support benefit for being able or expected to work. This is because only federal supplementation benefits would be available, and these are less than half the combined federal supplementation and provincial support guarantees. Leaving aside Quebec which imposes the largest penalty, employability appears to reduce social assistance benefits by 28 to 35 per cent or roughly $2,000. The PD option thus appears to impose a relatively severe penalty on employability for single unattached non-elderly adults with no other sources of income.

Finally, let us consider the incremental effect on basic income needs of a second adult in a family. From the low-income lines in Table 3, the presence of a second person (assumed to be an adult in this discussion) adds between one-third and two-thirds to the amount of income needed. Leaving aside the CCSD lines, which embody the highest relativity, the incremental needs of a second adult appear to be about 40 per cent of those of the first adult. In absolute dollar terms, the *average* needs of two adults are in the range of $4,300 to $8,700 *per person* according to the low income or poverty lines (i.e., half the dollar amounts in the second column).

The social assistance figures in Table 4 do not allow direct inferences about the effect on basic needs of the presence of a second adult. However, we can compare a couple with two children to a single parent with one child or a single disabled person to draw some rough inferences. More detailed data on provincial social assistance benefit structures show, for example, that a second child typically adds as little as half as much to a family's benefits as the first child. If we assume that two children have 1.5 times the effect of one child on the basic needs of a family, we can infer that a second adult adds between 13 per cent and 52 per cent to the first adult's basic needs. Taking this range and applying it to the basic needs of a single disabled person implies *average* basic minimum income requirements of $3,800 to $5,300 *per adult* in two-adult families.[11]

Finally, the 1986 OAS plus GIS guarantee of $13,348 for an elderly couple can be taken to imply that a second person adds 74 per cent to basic needs and that these basic needs amount to about $6,700 per adult in a couple.

The PD option emphasizes neutrality as one of its objectives and thus tries to avoid making the basic guarantees conditional on marital status and family composition; the exception is benefits for the elderly, where the intent is to mimic the GIS benefit

structure. As a result, the guarantees are so much per adult, and it follows that a second adult is treated as adding 100 per cent to basic needs. At $5,640 per adult, the PD option guarantees are high compared to the implied social assistance benefit levels for couples, modest compared to the low-income and poverty lines, and low compared to federal OAS/GIS guarantees for the elderly.

More generally, the PD guarantees appear low as compared to social assistance benefits for smaller family sizes, but they tend to exceed social assistance benefit levels for larger families. For example, the PD guarantees would amount to $8,100 per year for a single parent with one child, compared to between $8,800 and $9,200 for social assistance plus Family Allowance and the child tax credit. On the other hand, a couple with two children would be entitled to $16,200 per year under the PD option, considerably more than current social assistance benefits which are in the range of $10,900 to $13,200.

These comparisons highlight the extent to which provincial social assistance benefit structures assume, for example, that two persons living together need considerably less than twice the amount needed by a single person living alone. Correspondingly, given that the PD benefit structure is neutral with respect to marital status and living arrangements (except for the elderly), the comparisons reveal the non-neutralities implicit in current social assistance benefits. These non-neutralities are most vividly illustrated by the 'man in the house' rule whereby social assistance can be denied to a single mother depending on how frequently a boyfriend visits.

Most of the economies of scale for households arise in the area of shelter costs. Thus, one strategy for recognizing these economies without doing too much harm to the neutrality objective would be to break the basic income guarantees into two parts. One part could be related to shelter costs, and hence implicitly to family size, while the other would be smaller than the PD guarantees but still neutral with respect to marital status and family composition. Introducing some sort of shelter allowance along these lines would allow an increase in the PD option guarantees for single parent families, and thus should probably be pursued in any subsequent development of this kind of reform.

The discussion of adequacy so far has focused on the PD option. The MT option, in contrast, leaves CAP and social assistance benefits unchanged. The main impact is an increase of $450 per non-elderly adult and $225 per child in the refundable sales tax credit, resulting in a modest improvement in the adequacy of existing basic income guarantees. This assumes that the provinces would not subsequently adjust their social assistance benefit levels downward as a result of the unilateral federal improvements.

Quantitative Simulation Results

In this section, we turn to a fairly detailed examination of the results of a series of computer simulations of the MT and PD reform options, as well as comparisons of them to the status quo (abbreviated as SQ). These simulations were all performed with the Volksmodel, a personal computer-based micro-simulation model.[12]

The simulation results are summarized in a series of tables showing the major overall results, the broad vertical and horizontal redistributive effects, and the effects on marginal and average effective tax rates. In all cases, the MT and PD options are simulated as if they had been in place in 1986. In the case of the overall results and the redistributive effects, the underlying data on individuals and families, their incomes, and other socio-economic characteristics are from 1982. All dollar items have been re-expressed in 1986 terms simply by inflating them by 20% to reflect the change in the CPI over the four-year period.

It is important to emphasize that the simulation results are impact estimates. They show the effects of changing program parameters and tax provisions on the assumption that no one changes his or her behaviour. For example, it is assumed that UI cuts do not cause people to change the number of weeks they work in a year and that changes in marginal tax rates do not affect peoples' work effort or propensity to save.

This lack of attention to behavioural responses is an important caveat in interpreting the results. However, it is not unreasonable in the current circumstances. The most important reason to be satisfied with first round impact estimates is that there is no robust, comprehensive and broadly accepted set of descriptions of what the behavioural responses would be. The academic literature, for example, continues to produce a wide range of estimates of labour supply elasticities (Osberg 1986). Even if there were some degree of convergence in estimated elasticities, most analysts would want to examine the first-round impact estimates for any social or tax policy initiatives. (The simulation software is being developed to incorporate the possibility of behavioural response. For example, in future, it will be possible to examine the impact of a particular reform option given various assumptions about labour supply behaviour.)

A final caveat concerns numerical accuracy. Even though the computer software produces numbers that look accurate, generally only the first two digits should be considered. This limited degree of accuracy derives principally from the fact that the underlying data are drawn largely from a sample (about 0.4 per cent of all Canadians) and that the Volksmodel software embodies a range of simplifying assumptions (in order to squeeze the model and database down so they fit on a personal computer).

Overall Results. Table 5 shows the main overall results. The population of families (i.e., nuclear families and unattached individuals) has been divided into three broad groups: the elderly (at least one spouse age 65 or over), families with children (couples and single parents with at least one child under age 18), and others (non-elderly unattached individuals and couples without children under age 18). As shown in the lower right corner, both options are fiscally neutral overall. This, of course, is by design – the parameters of the MT and PD options were adjusted to achieve this net fiscal balance between households and governments, as well as for the federal and provincial governments individually.

Judging by the proportion of gainers and losers, the MT option would appear not to be politically viable. More than half of all families could expect to lose, compared to about

TABLE 5: Major Overall Results

Demographic Group	Elderly		Families With Children		Others		All Families	
Reform Option	MT	PD	MT	PD	MT	PD	MT	PD
Population (millions)								
Families	2.0		3.8		4.6		10.3	
People	2.7		14.8		7.4		24.9	
Gainers and Losers (percentage of families)								
Gainers	51.9	73.5	30.2	56.5	33.4	34.7	35.7	50.1
Losers	14.5	13.1	69.4	42.9	53.7	64.4	52.0	46.7
No Change (less than $10)	33.6	13.4	0.4	0.7	12.9	0.9	12.3	3.2
Average Amounts per Family ($)								
Status Quo Incomes								
Market (Labour plus investment)	15,725		36,850		28,900		28,300	
Total (Market plus transfers)	22,700		39,375		30,300		32,175	
Disposable (Total minus taxes)	19,900		32,075		24,050		26,200	
Post-Reform Disposable Income	19,800	20,125	32,025	32,300	24,125	23,775	26,200	26,200
Disposable Income Changes								
Average (all families)	-100	225	-50	225	100	-275	-	-
Gainers only	175	950	625	1,375	475	1,800	450	1,375
Losers only	-1,450	-3,675	-325	-1,275	-125	-1,400	-300	-1,475
Aggregate Effects ($ billions)								
Post-Reform Disposable Income								
Heads of households	32.0	31.1	86.5	81.1	85.3	81.3	203.8	192.6
Spouses	4.9	6.4	24.7	31.1	16.2	18.4	45.8	57.0
Change from Status Quo								
Heads of households	-0.2	-1.0	0.8	-4.6	0.5	-3.4	1.1	-9.1
Spouses	-	1.4	-1.0	5.5	-0.1	2.1	-1.1	9.1
Net	-0.2	0.4	-0.2	0.9	0.4	-1.3	-	-

Source: 1982 Social Policy Simulation Database inflated by CPI to 1986 and Volksmodel simulations compared to existing 1986 tax and transfer structure.

36 per cent who could expect to gain from the MT package of reforms. In contrast, about half of all families could expect to gain under the PD option, slightly more than the 47 per cent who could expect to lose.

Looking across family types, the MT option redistributes from the elderly and families with children under 18 to other families; the PD option has the opposite effect. In the case of the MT option, this is the net result of cutting back Family Allowance and OAS and putting the resulting monies into the sales tax credit – and hence relatively more into the hands of unattached individuals and childless couples. The PD option, on the other hand, increases child guarantees in the new supplementation tier above the level of Family Allowance and the child tax credits and implicitly replaces GIS with a similar basic income guarantee, but one subject to a lower effective tax rate than the 50 per cent tax-back rate on GIS.

The MT and PD options also have opposite effects on redistribution between spouses: the MT makes family heads (mainly men) better off while the PD option makes spouses (mainly women) better off. Most of the losses to spouses in the MT option result from the Family Allowance cuts. In the PD option, the abolition of Family Allowance and the child tax credit is more than offset by paying the child guarantees as well as the spouse's own adult guarantee to the spouse. These inter-spousal transfers illustrate a broader point, namely that the feminist criticism that a guaranteed annual income will penalize women, while correct for the MT option and Macdonald's UISP, is not always so (see Townson 1987).

Furthermore, the extent of redistribution is much greater under the PD option than under MT. For example, the PD option redistributes about 10 times as much between heads and spouses, and from two to 10 times as much in terms of average dollar gains and losses.

The largest average loss is $3,675. This arises under the PD option for the elderly. It applies to 13.1 per cent of the elderly, compared to an average loss of $1,450 under the MT option for 14.5 per cent of the elderly. On the other side, PD provides average gains of $950 to 73.5 per cent of the elderly while MT provides average gains of $175 to 51.9 per cent of the elderly. The overall effect of these different mixes of gainers and losers and average dollar gains and losses is a net loss to the elderly of $200 million under the MT option and a net gain in disposable income of $400 million under the PD option (bottom row of Table 5).

Considering average family incomes, it is interesting to note that the disposable income of the elderly, unlike any other group, is higher than their market income. This results from the fact that average transfers to the elderly ($6,975 = $22,700 - $15,725) are larger than the average income taxes they pay ($2,800 = $22,700 - $19,900). At the same time, the elderly have the lowest average incomes, while families with children have the highest (under all three definitions – market, total, and disposable).

Vertical Redistribution. Table 6 shows the broad redistributive effects of the MT and PD options by income group. These income groups are defined in a special way. All

TABLE 6: Redistributive Effects of the MT and PD Reform Options Compared to the Status Quo

Status Quo Disposable Income Percentile Group	Average Incomes ($)					Ratios (%) to Market Income of			
			Disposable Income				Disposable Income		
	Market Income	Total Income	Status Quo	MT Option	PD Option	Total Income	Status Quo	MT Option	PD Option
0-10	1,825	4,725	4,750	5,175	6,025	260.1	262.3	285.9	332.3
10-20	3,100	8,825	8,975	9,200	9,400	284.7	289.5	297.0	303.4
20-30	9,725	13,650	12,650	12,875	13,350	140.2	130.0	132.4	137.2
30-40	14,125	18,450	17,000	17,250	17,375	130.4	120.3	121.9	122.9
40-50	20,100	23,425	20,925	21,000	21,025	116.5	104.1	104.5	104.6
50-60	27,325	29,675	25,300	25,275	25,450	108.5	92.6	92.5	93.1
60-70	34,225	36,150	30,100	29,975	30,325	105.6	87.9	87.6	88.6
70-80	41,700	43,550	35,250	35,100	35,350	104.5	84.5	84.2	84.8
80-90	52,975	54,350	42,775	42,550	42,325	102.6	80.7	80.3	79.9
90-95	66,725	67,950	52,075	51,475	51,000	101.8	78.1	77.2	76.4
95-100	109,175	110,225	76,575	75,825	71,925	101.0	70.1	69.5	65.9
All	29,300	32,175	26,200	26,200	26,200	109.8	89.4	89.4	89.4

Note: Dashes indicate the point along the family income spectrum where the reforms switch from providing average net gains to causing average net losses.

Source: See Table 5.

nuclear families and unattached individuals (i.e., families) were ranked in increasing order of their disposable incomes under the present system. Then they were divided into 10 groups of equal size; the top group was further divided in half. This resulted in 11 groups identified by how far along the income spectrum they were located. For example, the 40th to 50th percentile group consists of all families with disposable incomes above the bottom 40 per cent of the population and below the top 50 per cent.

To continue the example, this group had an average income from market sources of $20,100. Because of various government transfers, their total income was $3,325 higher on average at $23,425, while federal and provincial income taxes and payroll taxes of about $2,500 reduced their disposable income back to about $20,925.

Under the MT option, the group in the 40th to 50th percentile would be about $75 ahead, while they would be about $100 better off under PD. Looking down the disposable income columns, families on average are better off until we reach the 50th percentile under the MT option and until the 80th percentile under the PD option (shown by the dashes). Thereafter they are worse off. Thus, both the MT and PD options are broadly progressive in their redistributive effects.

It is important to note that Tables 5 and 6 are *not* inconsistent regarding the proportion of gainers and losers. For example, Table 5 shows 35.7 per cent of all families gaining under the MT option, while Table 6 shows families gaining *on average* up to the 50th percentile. However, Table 6 does not reveal the fractions of gainers and losers within each percentile group. Even though one of these groups will either gain or lose on average, there will typically be both gainers and losers within each percentile group. We return to this point below in discussing Table 8. It is sufficient at this point to emphasize that analyses based only on average effects by income group can be seriously misleading.

Perhaps the most important observation to be drawn from Table 6 is highlighted in the last four columns. Here, total income and disposable income under three scenarios (status quo, MT and PD) are expressed as percentages of market income for each income group. The key point is that in any row, disposable incomes are much closer to one another than they are to 100 per cent. In other words, the amount of redistribution under the status quo is already quite substantial. Even though the MT option – and the PD option more so – may appear radical, they still result in volumes of redistribution that do not look too different from what is already going on. The one caveat is that this conclusion applies to average amounts of vertical redistribution by broad income group.

Table 7 provides a somewhat more detailed picture of the redistributive effects by the same broad demographic groups shown in Table 5. As in Table 6, families have also been divided into percentile income groups. However, this time the percentiles have been determined separately for each demographic group. Thus, for example, the 20th to 30th percentile group corresponds to average disposable incomes of $9,275, $20,875, and $10,225 for the elderly, families with children, and others respectively. Elderly families have the lowest incomes on average in most percentile income ranges. For example, the 60th to 70th percentile group of the elderly has a lower income ($19,675) than families with children in the 20th to 30th percentile group ($20,875) and a lower income than the 40th to 50th percentile of all family types combined ($20,925). However, the bottom 20

TABLE 7: Proportionate Changes in Disposable Income (%) by Income and Demographic Group

Status Quo Disposable Income Percentiles	Elderly			Families With Children			Others			All Families		
	Average Pre-Reform Income ($)	Average Change (%)		Average Pre-Reform Income ($)	Average Change (%)		Average Pre-Reform Income ($)	Average Change (%)		Average Pre-Reform Income ($)	Average Change (%)	
		MT	PD		MT	PD		MT	PD		MT	PD
0 - 10	7,900	0.1	0.4	9,050	8.4	22.3	2,925	15.8	54.0	4,750	9.0	26.6
10 - 20	8,625	0.1	0.6	15,875	4.7	14.2	6,350	5.7	8.6	8,975	2.6	4.8
20 - 30	9,275	0.1	2.4	20,875	1.2	1.5	10,225	1.9	-0.2	12,650	1.8	5.5
30 - 40	10,900	0.5	5.9	24,950	-0.4	0.7	14,475	0.5	-0.3	17,000	1.4	2.2
40 - 50	14,050	1.3	3.8	28,800	-0.8	1.0	18,350	0.1	-1.2	20,925	0.4	0.5
50 - 60	16,975	0.5	0.1	32,425	-0.8	1.3	22,750	-0.1	-2.1	25,300	0.0	0.6
60 - 70	19,675	0.0	2.3	35,600	-0.7	0.7	27,475	0.0	-1.3	30,100	-0.4	0.7
70 - 80	23,075	0.6	5.7	40,300	-0.6	0.0	33,250	0.0	-1.1	35,250	-0.4	0.3
80 - 90	29,650	0.7	4.9	46,975	-0.8	-1.0	41,275	-0.2	-2.0	42,775	-0.5	-1.1
90 - 95	40,925	-1.4	1.5	55,375	-1.2	-2.7	51,700	-0.2	-1.5	52,075	-1.1	-2.1
95 - 100	76,975	-4.0	-7.6	76,250	-1.0	-5.8	75,025	-0.1	-5.9	76,575	-1.0	-6.1
All Incomes	19,900	-0.6	1.1	32,075	-0.1	0.7	24,050	0.4	-1.2	26,200	0.0	0.0

Source: See Table 5.

per cent of the elderly have higher disposable incomes than the bottom 20 per cent of other families (mainly non-elderly unattached individuals). Moreover, the top 5 per cent of the elderly have a higher average disposable income than the top 5 per cent of either of the other two demographic groups. Even though the elderly have below-average incomes overall, the well-off among the elderly are just as well-off as their counterparts in other groups.

Within each of these three demographic groups, it is clear from Table 7 that both the MT and the PD option are broadly redistributive from upper to lower incomes. Proportionate changes in disposable income as a result of the reforms are positive at the bottom of the income spectrum and generally decline as one moves up the scale. The largest exception is for the elderly. Under the MT option, this arises for two main reasons. First, OAS has been made non-taxable; second, a portion of GIS has effectively been replaced by the increase in the refundable sales tax credit. This latter change means in turn that a benefit that was income-tested starting with the first dollar of income at a rate of 50 per cent has been replaced by a benefit that is income-tested at a rate of only 10 per cent on income above an $8,000 threshold. Somewhat similarly, under the PD option GIS is replaced by a benefit that provides almost identical guarantees but is income-tested at a 40 per cent rather than a 50 per cent rate.

The MT option generally has more losers in the middle income ranges. This is because all benefit improvements (other than making OAS non-taxable) are focused on the lower income ranges via the ten-fold increase in the refundable sales tax credit. It is also evident that the MT option tends to redistribute from the elderly and families with children to other families. In this latter regard, the effect is the opposite of results of the PD option.

Finally, in terms of average percentage changes within each demographic/income group, the MT and PD options often have effects of similar magnitude. By contrast, Table 5 shows redistributive effects that are as much as 10 times as great under the PD as under the MT option. The implication is that the PD option involves roughly similar amounts of vertical redistribution but much greater horizontal redistribution (i.e., within demographic/income groups) than the MT option. This is to be expected. The PD option moves from a more complex to a simpler tax/transfer system; thus, even though the results are simpler, the changes in disposable income compared to the status quo, which embodies the complexities of the current tax and transfer systems, are necessarily more varied.

Horizontal Redistribution. The wider range of effects under the PD option as compared with the MT option is illustrated in Table 8. Moving down the rows, families were sorted in ascending order of their disposable income under the current system and divided into percentile groups exactly as in Table 6 and in the last columns of Table 7. Then, moving across the columns within each income percentile group, families were sorted according to the extent of the gain or loss in disposable income that would result from the reform option, ranging at the bottom from the smallest gain or largest loss to the top with the largest gain or smallest loss. This spectrum of gains and losses within each

TABLE 8: Average Gains and Losses ($) by Income and Gain/Loss Group

Option	MT Option				PD Option			
Gain/Loss Group*	Bottom 10%	25 to 50%	50 to 75%	Top 10%	Bottom 10%	25 to 50%	50 to 75%	Top 10%
Status Quo Percentile Disposable Income Group:								
0-10	0	450	450	1,375	-575	675	1,800	6,625
10-20	0	0	325	1,025	-800	25	500	3,625
20-30	-175	50	300	1,350	-1,100	75	775	6,525
30-40	-275	0	125	875	-2,350	-475	225	3,200
40-50	-325	-25	75	625	-2,300	-475	650	2,825
50-60	-475	-175	-25	450	-1,840	-550	550	2,975
60-70	-450	-225	-100	125	-1,675	-550	325	2,475
70-80	-425	-225	-125	100	-1,775	-275	575	2,225
80-90	-600	-225	-150	0	-3,350	-925	-125	1,400
90-95	-2,225	-600	-325	0	-3,900	-1,700	-1,125	450
95-100	-4,135	-700	-350	-25	-12,750	-5,275	-3,275	-600

* See text for explanation.

Source: See Table 5.

income group was then divided into percentile groups, but with different break points: 0 to 10, 10 to 25, 25 to 50, 50 to 75, 75 to 90, and 90 to 100 per cent. Of these six percentile gain/loss groups, Table 8 shows the results for the first, third, fourth, and sixth groups (i.e. the bottom tenth or decile, two middle quarters or quartiles, and the top decile of gain/loss respectively).

Table 8 shows that the poorest 20 per cent can expect no losses under the MT option (i.e., the top two rows have no negative net gains under MT) while a small fraction of this income group (about 10 per cent) can expect to lose under the PD option. On the other hand, the prospective gains under the PD option for the poorest 20 per cent are much larger than under the MT option. For example, those among the poorest 10 per cent (the first row of the table) and in the upper middle (50 to 75 per cent) or top (Top 10 per cent) of the gain/loss range can expect increases in disposable income about four times larger under PD than under MT ($1,800 and $6,625 versus $450 and 1,375 respectively).

Correspondingly, at the top of the income spectrum, the PD option imposes more substantial losses. For example, families in the top 5 per cent of the income spectrum and in the bottom 10 per cent of the gain/loss spectrum (i.e., in the bottom row and the first and fifth columns, representing 0.5 per cent of all families) can expect roughly three times as great a loss in disposable income from the PD as from the MT option – an average loss of $12,750 versus $4,135. (In the underlying data, this top 5 per cent of all families has disposable incomes ranging from $58,000 to $218,000.)

As already noted, there are two ways to read Table 8. The first obvious point is that the PD option at every level of income would generate a broader range of gains and losses than the MT option. Thus, it is substantially redistributive horizontally as well as vertically. A corollary, however, flows from the fact that the PD option was designed to be simple and generally neutral. The relatively large gains and losses under the PD option within each income group can therefore also be taken as showing how far away the tax and transfer systems are from at least one view of relative simplicity and neutrality or indeed horizontal equity – that embodied in the design of the PD option.

Marginal Tax Rates. Effective marginal income tax rates (MTRs) are an essential component in the relative prices faced by individuals selling their labour services and purchasing current versus future consumption via the taxation of labour income and of investment income, respectively. Thus, major concerns about options for reforming taxes and transfers focus on the effects of these reforms on MTRs and hence on incentives.

The salience of MTRs to peoples' actual behaviour is not entirely clear. The empirical evidence is certainly mixed (Osberg 1986). Furthermore, even if one could imagine a public opinion polling firm posing the question in a way that is comprehensible to most Canadians, it is not clear that most know their own MTR to within five percentage points. In turn, if most people do not know their MTR with any precision, it is difficult to see how small changes (less than 5 percentage points, say) or even modest changes in MTRs could have any significant impact on behaviour. Certainly many recent income tax

changes involving marginal tax rate changes in the range of 1 to 5 percentage points (e.g., introduction of the child and sales tax credits with their 5 per cent tax-back rates, the federal high-income surtaxes in 1985 and 1986, and the phase-out of the $200 basic federal tax reduction) do not appear to have had any noticeable effects on economic activity.

Notwithstanding these possible limitations, Table 9 presents MTRs for the status quo (SQ) and the two reform options (MT and PD) for a set of hypothetical families. This set consists of three pure stereotypical families arrayed along a range of points on the income spectrum. (Recall from Table 6 that about 50 per cent of all families have market incomes under $25,000 and 90 per cent have market incomes under about $55,000. Thus, about 10 per cent of families would find the last four rows of Table 9 applicable.) The margin in the case of the MTRs in Table 9 is an extra $100 of employment income.

The first observation worth drawing from the table is that at present, MTRs are complex and counter-intuitive. Nowhere in the table are there tax rates that resemble the 10 basic federal rates on the detailed tax calculation schedule of the federal income tax return. On top of the federal rates are provincial income taxes, surtaxes, payroll taxes, and GIS, child tax credit, and federal sales tax credit tax-backs (as well as tax-backs associated with provincial sales and property tax credits, hospital insurance premium assistance, public housing, day care, and educational assistance, none of which is considered here). Even with the exclusion of social assistance, under the status quo (SQ), MTRs do not increase uniformly with income – note the 80 per cent MTR for the elderly couple at $10,000 of income resulting from the overlap between GIS and the positive income tax system, as well as the decline in the MTR for the couple with two children after $40,000 because of the phase-out of the child tax credit tax-back. It is difficult to imagine many Canadians knowing in any detail, let alone understanding, their MTRs under the current tax and transfer systems.

The MT option shows even greater complexity and variation in MTRs. This is the result of the new tax-backs on OAS and Family Allowance, the expanded role of the refundable sales tax credit, and the increased overlap between GIS and the positive income tax system resulting from abolition of the age exemption. The MTRs for the MT option illustrate the worsening hodgepodge that could easily result from a continuing series of piecemeal reforms to the tax and transfer system in the absence of a coherent plan or objective. In almost all cases, MTRs are the same or higher under the MT option than under the status quo, and in many cases they are significantly higher (i.e., by more than 5 percentage points).

Before turning to the PD option and its MTRs, it is worthwhile to consider briefly recent U.S. tax reforms and the move there to an almost flat-rate tax. The media have focused on the 15 and 28 per cent tax rates resulting from this reform. However, these rates refer to U.S. federal income taxes only, in a society where public health insurance is limited in scope and payroll taxes are considerably higher; moreover, the rate cuts are accompanied by a major increase in corporate income taxes. If in this Canadian analysis we suppose there will not be sharply increased reliance on corporate or commodity taxes, and if we include both federal and provincial income taxes, payroll taxes, and tax-backs in social transfer programs, then it is simply not possible for overall MTRs of 15 and 28 per

TABLE 9: Marginal Effective Income Tax and Tax-Back Rates

Non-Transfer Income ($)	Single, Non-elderly			Elderly Couple			Couple, 2 Children		
	SQ	MT	PD	SQ	MT	PD	SQ	MT	PD
Eligible[a]									
0	100?	100?	76.4	100?	100?	76.4	100?	100?	76.4
5,000	100?	100?	77.5	50.0	50.0	36.4	100?	100?	77.5[b]
10,000	28.0	37.6[c]	37.5	80.3[d]	83.8[d]	36.4	100?	100?	77.5[b]
Not Eligible[a]									
0	1.8[b]	1.8[b]	36.4	50.0	50.0	36.4	1.8[b]	1.8[b]	36.4
5,000	12.2[b]	12.2[b]	37.5[b]	50.0	50.0	36.4	3.6[b]	3.6[b]	37.5[b]
10,000	28.0	37.6[c]	37.5	80.3[d]	83.8[cd]	36.4	12.2	21.8[c]	37.5[b]
15,000	29.6	29.6	36.4	28.3	36.8[c]	36.4	28.1	37.9[c]	36.4
16,000	33.1[h]	29.6	36.4	28.3	38.3[c]	36.4	33.0[h]	37.9[c]	36.4
20,000	29.8	29.8	36.4	28.3	27.3	36.4	28.3	38.3[c]	36.4
25,000	34.2	34.2	36.4	29.8	29.8	36.4	34.8[e]	34.8[e]	36.4
30,000	37.2	37.2	36.4	34.2	44.2[f]	36.4	39.2[e]	39.2[e]	36.4
35,000	37.8	37.8	36.4	37.2	47.2[f]	36.4	42.2[e]	42.2[e]	36.4
40,000	37.8	37.8	36.4	37.8	47.8[f]	36.4	42.8[e]	42.8[e]	36.4
45,000	45.4	45.4	56.7	45.4	55.4[f]	56.7	37.8	42.8[g]	56.7
50,000	45.4	45.4	56.7	45.4	55.4[f]	56.7	45.4	50.4[g]	56.7
60,000	45.4	45.4	56.7	45.4	55.4[f]	56.7	45.4	45.4	56.7
75,000	51.4	51.4	56.7	51.4	61.4[f]	56.7	51.4	51.4	56.7
100,000	51.4	51.4	56.7	51.4	61.4[f]	56.7	51.4	51.4	56.7
150,000	51.4	51.4	56.7	51.4	51.4	56.7	51.4	51.4	56.7

Notes:
a. For provincial social assistance or GIS top-ups (SQ and MT) or provincial support tier (PD).
b. Includes C/QPP contributions and UIC contributions (SQ and MT only).
c. Note stacking of 10 per cent sales tax credit tax-back rate.
d. Overlap of GIS and positive tax system.
e. Note stacking of 5 per cent child tax credit tax-back.
f. Note stacking of 10 per cent OAS tax-back.
g. Note stacking of 5 per cent FA tax-back.
h. Note stacking of 5 per cent tax-back for the refundable sales tax credit; does not appear for elderly because of inclusion of OAS in net income.

• Sidebars on right (left) indicate more than a 5 percentage point increase (decrease) in effective marginal tax rates.

Source: Volksmodel applied to hypothetical families and 1986 tax/transfer structure.

cent to raise the required amounts of revenue. Indeed in the U.S., actual post-reform MTRs will be considerably higher when state income and payroll taxes are included.

This potentially misleading view of U.S. post-reform tax rates should be borne in mind when considering the MTRs in the PD option. The MTRs in Table 9 are comprehensive. They include federal and provincial income taxes, which themselves effectively constitute the tax-back on a new nation-wide income supplementation program, payroll taxes, and the 40 per cent tax-back on provincial income support benefits.

Even if the MTRs have the results typically assumed by neo-classical economic theory, the behavioural effects of the PD option are difficult to judge. The reason is simply that in some income ranges MTRs are higher and in others they are lower under the PD option than under the SQ. For example, under the PD option a couple with two children would face a significantly higher MTR (i.e., more than five percentage points higher) if their income was under $20,000 (about 30 per cent of all families with children – recall Table 6) and they were *not* receiving social assistance. (If they were, their MTR would drop significantly from 100 per cent to about 75 per cent.) In the $25,000 to $30,000 range (about 20 per cent of all families with children), there would be essentially no change; in the $35,000 to $40,000 range (about 30 per cent of families with children), their MTRs would drop significantly under the PD option, while in the $45,000 to $60,000 range (about 15 per cent of families with children) MTRs would increase significantly. Above $60,000 (about 5 per cent of families with children) it is not clear that increased MTRs would be behaviourally significant.

On balance, it is probably fair to say that the PD option represents only modest progress on the objective related to incentives. As noted at the outset, we should not be too surprised if an option with such diverse objectives fails to achieve major improvements on all fronts. If the reader feels more weight should be given to reducing MTRs, the PD option could easily be amended to lower the tax rates. This would in turn require either a reduction in basic guarantees or an injection of new monies.

Irrespective of the precise level of the basic tax rate, the simpler and closer to neutral design of the PD option may have other behavioural effects. A key point is that most people most of the time would be facing essentially the same MTR. In turn, this means that income splitting and income averaging would become generally fruitless.

Finally, Table 9 does not reflect the effects of the 30 per cent cut in UI benefits under the PD option nor the 10 per cent cut under the MT option. Such cuts would have a more complex effect on MTRs and incentives, one that has not been extensively analysed empirically at the micro-economic level.

Average Tax Rates. According to conventional neo-classical economic theory, behaviour is influenced by both income and substitution effects. Substitution effects relate to changes in relative prices or rewards (e.g., work and leisure), and the MTRs just discussed are the relevant factors. For the income effects, however, average changes in disposable income or average effective income tax rates (ATRs) are relevant. (For

example, someone who wins a lottery may not face a change in their after-tax wage rate, but the income effect might still induce them to quit work.) Table 10 shows ATRs for the same stereotypical families and most of the income levels examined in Table 9.

In general, the results in Table 10 mirror those in Table 7. Both MT and PD are broadly progressive in their redistributional effects. PD provides more to the elderly and families with children than the MT, but less to others. This is indicated by the locations of the dashed lines in Table 10, which show the incomes where the reform options move from ATRs lower than the status quo to ATRs higher than the status quo.

More generally, it is interesting to observe the extent to which net tax/transfer liabilities are negative, indicated by negative ATRs. This means that transfers, refundable tax credits, or basic guarantees exceed taxes owing, and hence that the family is a net beneficiary of rather than a payer to the state. These cross-over or break-even points are indicated by solid lines in Table 10. For all three family types, and notwithstanding the fundamental reforms implied by the PD option, these break-even points are relatively similar across the SQ, MT, and PD scenarios.

Indeed, the differences between scenarios for each family type and income level are generally smaller than those between family types or income levels within each scenario. This reinforces an observation drawn earlier from Table 6, namely that the status quo already involves substantial redistribution. Thus, moving from the SQ to the MT or PD scenarios entails redistributive changes that are small compared to the movement Canada has already made since the nineteenth century, when there were essentially no taxes or government transfers.

Transitional Considerations

The MT option, by design, can be implemented fairly readily. All the changes involve unilateral federal actions. The changes can be broken into smaller packages and phased in gradually according to more detailed priorities and considerations. The refundable sales tax credit, even when fully phased in, would be small enough that year-end delivery could continue. Thus, no changes at all would be required in existing administrative arrangements.

The PD option, by contrast, poses much more difficult problems. The option is so different from the status quo that it is difficult to imagine a gradual transition in terms of administration and delivery. There are major gainers and losers, so that any gradual phase-in for the net benefit structure would likely risk a protracted period of opposition from the prospective losers. As well, the provinces are assumed to make major changes in their taxes and transfers, meaning that a complex series of federal-provincial negotiations would be required. Not the least of the issues is the presumption inherent in the PD option that income supplementation should be a federal responsibility and should be uniform across the country.

With all these strikes against it, why proceed any further with consideration of the PD option? The basic reason is that if there is to be any significant improvement in our

TABLE 10: Average Effective Tax/Transfer Rates

Non-Transfer Income ($)	Single, Non-elderly			Elderly Couple			Couple, 2 Children		
	SQ	MT	PD	SQ	MT	PD	SQ	MT	PD
5,000	2.3	-6.7	-14.0	-229.8	-231.0	-243.9	-33.3	-57.1	-103.6
10,000	13.1	9.7	11.8	-84.1	-86.3	-103.8	-14.3	-24.2	-33.0
15,000	18.7	19.0	20.3	-34.7	-38.8	-57.1	-1.0	-4.0	-9.5
20,000	21.7	21.7	24.3	-19.0	-20.3	-33.7	7.1	6.6	2.0
25,000	23.5	23.5	26.7	-9.2	-10.4	-19.7	11.7	12.7	8.8
30,000	25.4	25.4	28.4	-2.1	-3.1	-10.3	15.9	16.7	13.4
35,000	27.1	27.1	29.5	3.5	3.9	-3.7	19.4	20.1	16.7
40,000	28.5	28.5	30.4	7.8	9.4	1.3	22.2	22.9	19.2
45,000	30.0	30.0	33.3	11.3	13.7	7.5	24.2	24.8	23.3
50,000	31.6	31.6	35.6	14.7	17.9	12.4	26.1	27.2	26.7
60,000	33.9	33.9	39.1	19.8	24.1	19.8	29.3	30.8	31.7
75,000	36.8	36.8	42.7	25.4	30.7	27.2	32.8	34.0	36.7
100,000	40.4	40.4	46.2	31.9	38.4	34.6	37.4	38.4	41.7
150,000	44.1	44.1	49.7	38.4	42.8	41.9	42.1	42.7	46.7

Notes:
- Solid lines indicate the points on the income spectrum where families move from being net recipients to net payers of taxes/transfers.
- Dashed lines indicate the points along the income spectrum where the reform options start generating net losers instead of net gainers.

Source: Volksmodel applied to hypothetical families and 1986 tax/transfers structure.

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The MT option, by design, can be implemented fairly readily. All the changes involve unilateral federal actions. The changes can be broken into smaller packages and phased in gradually according to more detailed priorities and considerations. The refundable sales tax credit, even when fully phased in, would be small enough that year-end delivery could continue. Thus, no changes at all would be required in existing administrative arrangements.

The PD option, by contrast, poses much more difficult problems. The option is so different from the status quo that it is difficult to imagine a gradual transition in terms of administration and delivery. There are major gainers and losers, so that any gradual phase-in for the net benefit structure would likely risk a protracted period of opposition from the prospective losers. As well, the provinces are assumed to make major changes in their taxes and transfers, meaning that a complex series of federal-provincial negotiations would be required. Not the least of the issues is the presumption inherent in the PD option that income supplementation should be a federal responsibility and should be uniform across the country.

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10,000	13.1	9.7	11.8	-84.1	-86.3	-103.8	-14.3	-24.2	-33.0
15,000	18.7	19.0	20.3	-34.7	-38.8	-57.1	-1.0	-4.0	-9.5
20,000	21.7	21.7	24.3	-19.0	-20.3	-33.7	7.1	6.6	2.0
25,000	23.5	23.5	26.7	-9.2	-10.4	-19.7	11.7	12.7	8.8
30,000	25.4	25.4	28.4	-2.1	-3.1	-10.3	15.9	16.7	13.4
35,000	27.1	27.1	29.5	3.5	3.9	-3.7	19.4	20.1	16.7
40,000	28.5	28.5	30.4	7.8	9.4	1.3	22.2	22.9	19.2
45,000	30.0	30.0	33.3	11.3	13.7	7.5	24.2	24.8	23.3
50,000	31.6	31.6	35.6	14.7	17.9	12.4	26.1	27.2	26.7
60,000	33.9	33.9	39.1	19.8	24.1	19.8	29.3	30.8	31.7
75,000	36.8	36.8	42.7	25.4	30.7	27.2	32.8	34.0	36.7
100,000	40.4	40.4	46.2	31.9	38.4	34.6	37.4	38.4	41.7
150,000	44.1	44.1	49.7	38.4	42.8	41.9	42.1	42.7	46.7

Notes:
- Solid lines indicate the points on the income spectrum where families move from being net recipients to net payers of taxes/transfers.
- Dashed lines indicate the points along the income spectrum where the reform options start generating net losers instead of net gainers.

Source: Volksmodel applied to hypothetical families and 1986 tax/transfers structure.

current tax and transfer systems with respect to the objectives set out initially, then fundamental changes approaching the magnitude of those in the PD option are essential. Proceeding with something like the PD option presupposes a broad national consensus on the objectives and broad outlines of reform. In turn, such a consensus could emerge only from some combination of electoral platforms, a royal commission, government white papers and federal-provincial political discussions.

For the sake of argument, let us assume such a consensus would emerge. Then technically, how might governments proceed toward implementing something like the PD option? The most important starting point is probably the delivery system. Essentially, the federal government would have to move toward integrating the Supply and Services Canada (SSC) monthly cheque delivery system, Health and Welfare Canada's (HWC) application forms and local office network, and Revenue Canada-Taxation's (RCT) tax return processing system and administration of the source withholding system. Moves in this direction are already occurring with the recent change introducing delivery of the child tax credit in two instalments, with flows of information among RCT, HWC and SSC to keep address lists for Family Allowance current, and with crosschecks between RCT and HWC on net income reported for tax purposes and for GIS.

One scenario begins with the child benefit system. In terms of the benefit structure, the child tax credit would have to move in appearance toward a demogrant while personal exemptions were reduced to zero. More specifically, the turning point for income testing the child tax credit could be increased gradually from $23,500 while the marital and child exemptions could be reduced toward zero. Family Allowance could be made non-taxable so as to maintain approximate fiscal neutrality for both federal and provincial governments.

At the same time these changes in benefit structure were occurring, there would be changes in delivery. Child tax credits would start being paid monthly and would be combined in one cheque with Family Allowance. The general effect would be more tax withheld at source for fathers and larger monthly cheques to mothers. This increase in the gross flows of money back and forth between families and governments could be reduced somewhat by starting to link the monthly cheque delivery system to the source withholding system. For example, higher-income parents would be able to arrange on their source withholding form to get more take-home pay in lieu of a monthly cheque in respect of the children.

In the case of non-elderly adults, a slightly different strategy could be followed. The basic personal exemption could be reduced gradually to zero; at the same time, the refundable sales tax credit (only for non-elderly adults) would be increased gradually toward the basic federal guarantee under the PD option, the $15,000 point where income testing begins would be increased to make the credit begin to look like a demogrant. As the sales tax credit became larger, a shift to monthly delivery using a system similar to that for GIS would occur. As with child benefits, a link would have to be made between the source withholding system and the monthly cheques. Individual employees would in the first instance face reduced take-home pay resulting from the phasing out of the basic personal exemption, combined with larger monthly cheques from their refundable tax credits. However, they should be able to amend their source withholding forms so as to

increase their take-home pay by the amount of the refundable tax credit; after they had done so they would stop getting monthly refund cheques.

Admittedly, moving the child and refundable sales tax credits toward demogrants by gradually increasing their income testing thresholds runs counter to conventional wisdom about moving toward better targeting. However, it should be borne in mind that two other processes would be going on simultaneously; first, these demogrants would move to monthly cheque delivery and then to delivery to the extent appropriate via the source withholding system. Second, personal exemptions would be gradually phased out. Thus, another way to view this process is as the gradual conversion of personal exemptions to refundable tax credits.

As a further ingredient in this process, the ten federal income tax brackets would be gradually collapsed into the basic 29.5 per cent flat rate and the 16.5 per cent surtax. In addition to being a gradual transition to the PD option's tax rate structure, this process could also provide a degree of freedom to ensure that, at each step, the complete package of changes had an appropriate distributional impact. For example, tax rate and tax bracket changes could be designed so that they complemented increases in the $15,000 and $23,500 income testing thresholds of the sales and child tax credits and cuts in the basic personal, marital, and child exemptions.

This sketch of a gradual transition from the status quo to the PD option is akin to a conjecture in mathematics; it does seem possible, based on this brief sketch, to square the circle and move in gradual steps to implement a fundamental reform of Canada's tax and transfer systems. The full proof of the theorem that there exists a sequence of intermediate positions, each fiscally neutral for federal and provincial governments, and each involving a potentially reasonable set of redistributive effects compared to the prior position, will have to await a detailed micro-simulation analysis. Alternatively, such a transition might prove complex and obscure to the general public. Then, a cold turkey approach like the recent U.S. tax reform might prove more appealing.

Assessment and Concluding Comments

At the outset of this analysis, several objectives and constraints were set out to guide the development of options for the reform of Canada's tax and transfer systems. Two options were defined and analysed. These options, Modest Tinkering (MT) and Profound Demolition (PD), were designed as two polar illustrative cases spanning the range of reform options recently put forward. It is now appropriate to return to the initial objectives and constraints and to assess the success of the MT and PD options in their light. The results are summarized in Table 11.

Both options met most of their common initial design objectives. The main exception was the objective of introducing more opportunity for self-reliance, which has been taken to mean reduced marginal tax rates. If anything, MTRs are increased under the MT option because of new or enlarged tax-back provisions. The PD option has a mixed

TABLE 11: Assessment of the MT and PD Options

Objective or Constraint	MT Option	PD Option
Common Objectives:		
• Maintain universal access	yes	yes
• More to those most in need	yes	yes
• More opportunity for self-reliance	no, increased marginal tax rates	mixed
• Less to those with higher incomes	generally yes	generally yes
• fiscal neutrality	yes	yes
Constraints for MT (but not necessarily for PD)		
• No major changes to existing programs	yes	(no)
• No losers in the lower- and middle-income ranges	no	(no, but fewer than in MT)
• Feasible to implement via		
• Unilateral federal action	yes	(no)
• Small steps	yes	(maybe)
Added Objectives for PD (but not MT)		
• Major simplification	(no, worse)	yes
• Adequate basic income guarantees	(modest improvement)	substantial improvements for larger families
• Neutrality	(worse)	substantial improvement

impact in this regard; in some income ranges the simplified tax rate structure results in lower effective marginal tax rates while in others, marginal tax rates are higher.

Several constraints were proposed at the outset to guide the design of the MT option. All were met except the one regarding losers in the lower- and middle-income ranges. While this is clearly a desirable constraint, the MT option indicates that it is not easy to achieve with the limited initiatives that could be considered. The abolition or cutting back of tax expenditures caused losses in the lower-middle income range that could not be offset by increases in a more targeted refundable sales tax credit.

The design of the PD option, instead of being guided by additional constraints as in the case of the MT option, was guided by additional objectives. Generally, the PD option was quite successful in meeting these new objectives, particularly that of major simplification. The least successful area was that regarding adequate guarantees. Because substantial weight was given to the objective of neutrality, the idea of guarantees varying by family size was generally rejected; basic income guarantees varied only by age. In turn, this meant the guarantees could not reflect the economies of scale implicit in all the various standards of adequacy cited. As a result, the guarantees in the PD option appear barely adequate for small families but quite adequate for larger families. The PD option also achieved only mixed results with regard to improving incentives.

Overall, the MT option is feasible and implementable, but it appears somewhat incoherent and has such a high ratio of losers to gainers that it would probably not be worth the effort. The PD option, on the other hand, is much more ambitious and relatively successful. However, its sweeping changes would require more public discussion to generate a national consensus about the long-term objectives of such reform, as well as a fully articulated series of transitional measures.

Notes

1. We refrain from using the terms guaranteed annual income and guaranteed adequate income because the accounting period and level of the basic income guarantee are issues or design parameters to be discussed.

2. While the task force reported to Cabinet in the summer of 1977, an edited version of the paper was not tabled by the Minister of Finance until November 1978, two months after the announcement of the new refundable child tax credit.

3. It may be noted that the Business Council on National Issues (BCNI) seems to favour both MT and PD style options. In their December 1986 brief to the Minister of Finance on social policy, they explicitly rejected big bang reform and instead supported a series of incremental changes, including some very similar to the MT option described here. On the other hand, in their October 1986 brief on tax policy, the BCNI calls for fundamental reform and major restructuring of the tax system.

4. Budget Speech, February 26, 1986, page 12.

5. For simplicity, differences between the Quebec and other provincial income taxes have been ignored. Recall that under the federal-provincial Tax Collection Agreements, any change in taxable income in a province that reduces federal income tax revenues by one dollar generally reduces that province's income tax revenues by about 50 cents.

6. The PD option is basically an elaboration of the Guaranteed Income/Simplified Tax (GIST) presented in Wolfson (1986). In that case, the option was designed to parallel the Macdonald (1985) UISP proposal as much as possible. This was to highlight the failure of the UISP proposal to take account of the personal income tax system. For purposes of this paper, however, the GIST idea can be freed from the need to parallel the UISP. It has been renamed "profound demolition" so that any connotations in the name put it on an equal footing with the MT option.

7. The quantitative analysis below does not take account of possible behavioural changes, though they are discussed qualitatively.

8. As noted at the outset, we ignore the prospect of drawing upon increased sales or corporate income taxes. While this might be a politically fruitful tactic, from an economic perspective it is largely sleight of hand. People ultimately bear all taxes, either directly on their income or indirectly via some combination of higher prices, lower wages, or lower returns on their assets. (Of course, the ultimate distributional impact of higher sales, corporate or personal income taxes would likely be different.)

9. Guarantees for the elderly are not increased for the same reason as in the MT option – the programs for the non-elderly poor are less generous and are thus considered to be in greater need of improvement. The reduction in GIS tax-back

rates is consistent with the opening objective to "improve the opportunities for . . . self-reliance", which in this case means saving for retirement.

10. This is probably due to several factors: the complexity of each province's benefit formula, the large differences among provinces in these formulae, the substantial deviations in the amounts actually paid to social assistance beneficiaries from amounts calculated simply from a formula (in turn resulting from the discretion given to caseworkers), and the general unwillingness of several provinces to encourage public discussion of such comparisons.

11. For example, in the Atlantic provinces comparing a single parent with one child to a single disabled person, one child adds 41 per cent ($8,718 versus $6,199), so two children would add 61.5 per cent if we assume that a second child imposes half the additional burden of the first child, as provincial social assistance benefit formulae seem to do. Since a couple with two children is entitled to 188 per cent of the benefits of a single disabled person, the incremental impact of the second adult appears to be about 27 per cent (188 per cent minus 161 per cent) or $1,674. Adding $1,674 to $6,199 and dividing by two, we get an average of $3,937 per adult. A similar calculation for Quebec, Ontario and the West yields 36, 13, and 52 per cent for the relative incremental effects of a second adult, $2,035, $883, and $3,635 for the incremental dollar amounts, and $3,844, $3,836, and $5,313 for the average per adult respectively.

12. The Volksmodel is a simplified version of the Social Policy Simulation Database/Model (SPSD/M), a project being undertaken in the Social and Economic Studies Division, Statistics Canada. The objectives of the SPSD/M project include the development of an integrated tool (i.e., database and modelling software) for analysis of social and tax policy. This analytical capacity will soon be made available to the public.

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Annex A – Agenda

Workshop on
Approaches to Income Security Reform
September 23, 1986

A. Opening Remarks

B. Issues, Proposals and Options

What is the state of knowledge regarding approaches to income security reform? Is enough known at this point to proceed to a strategic and pragmatic approach to implementing reform? Or do the gaps in our understanding of the technical issues make such an approach unwarranted?

Design Issues

Discussion will be initiated by Richard Van Loon based on the first section of his background paper entitled "Discussion Paper on Tax and Transfer Reform".

Reform Proposals and Options

Discussion will be initiated by Richard Van Loon based on the reform models presented in his background paper.

Michael Wolfson will present two illustrative options, covering the spectrum of possible reforms, based on his background paper on "The Arithmetic of Income Security Reform".

C. Constraints and Opportunities

The Existing Income Security System

Is the existing income security system a constraint or does it provide a positive foundation on which to base reform? What strategies are required for the implementation of these reforms?

Administrative, Legal and Jurisdictional Constraints

What are the major administrative, legal and jurisdictional constraints to the reform of income security? What are the particular problems associated with federal-provincial jurisdictional issues?

Entrenched Entitlements/Public Perceptions

To what extent do entrenched entitlements and public perceptions act as constraints or opportunities for reform? What particular dimensions are most problematic?

D. Commitment and Decision-Making

Government Expectations and Objectives

What are the federal government's expectations and objectives regarding the existing income security system and its reform? How do these relate to provincial perceptions? Do the perceptions of the federal government act as constraints or stimuli to reform?

Consultation

To what extent can consultation ease some of the constraints noted above? Are there adequate ways of consulting with the public about reform proposals? What lessons can be learned from the past about effective approaches to consultation?

E. Concluding Remarks

Annex B – List of Participants

Workshop on
Approaches to Income Security Reform
September 23, 1986

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Approaches to Income Security Reform

Edited by
Shirley B. Seward
and Mario Iacobacci

After languishing on the back burner for almost a decade, income security reform is once again on the public policy agenda. Why this renewed interest?

The answer lies in part in dissatisfaction with current income security programs. The ideals of the post-war years – eliminating poverty, reducing unfair income distribution – have not been realized, despite the elaborate structures erected in the 1950s, 1960s and 1970s. What's more, the advent of economic recession in the 1980s – provoking a dramatic rise in unemployment and welfare caseloads – highlighted these inadequacies; programs are simply failing to respond to the needs of the long-term unemployed.

If this concern was not enough to revitalize debate about reform, a second argument was. The high cost of income security programs, along with the fact that programs like social assistance and unemployment insurance may actually deter people from seeking paid work, constitute barriers to Canada's economic efficiency and international competitiveness.

It was with these issues in mind that the Institute for Research on Public Policy organized a Workshop on Approaches to Income Security Reform in September 1986. Participants included leading actors from federal and provincial governments, business, labour and community organizations, universities and research institutions.

Is it possible to design a system that improves income security for those we most want to help while at the same time keeping costs manageable? Should we pursue wholesale changes to the entire tax and transfer system, or should we concentrate on smaller changes to a range of programs? These were among the questions the Workshop debated.

This volume contains an overview synthesizing the major issues discussed at the Workshop and two background papers prepared for the Workshop. The overview concludes with a suggested strategy for reform.

Shirley Seward is Director of the Studies in Social Policy program of the Institute for Research on Public Policy. Mario Iacobacci is a research assistant in the same program. Richard Van Loon and Michael Wolfson wrote the background papers. Now Assistant Deputy Minister, Self-Government, Department of Indian and Northern Affairs, Richard Van Loon was a professor in the Faculty of Administration, University of Ottawa, at the time he wrote the paper. Michael Wolfson is Director, Social and Economic Studies Division, Statistics Canada.

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